No. 75-1221

In the Supreme Court of the United States

OCTOBER TERM, 1975

Supreme Court, U. S.
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UNITED STATES OF AMERICA, PETITIONER

v.

CONSUMER LIFE INSURANCE COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

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The Solicitor General, on behalf of the United States of America, petitions for a writ of certiorari to review the judgment of the United States Court of Claims in this case.

OPINIONS BELOW

The recommended decision of the trial judge (App. A, *infra*, pp. 1a-66a) is not officially reported. The opinion of the Court of Claims (App. B, *infra*, pp. 67a-97a) is reported at 524 F.2d 1167.

JURISDICTION

The judgment of the Court of Claims was entered on October 22, 1975 (App. B, *infra*, pp. 67a, 129a).[1] By order dated January 15, 1976, the Chief Justice extended the time for filing a petition for a writ of certiorari to and including March 20, 1976. The jurisdiction of this Court is invoked under 28 U.S.C. 1255(1).

QUESTION PRESENTED

Section 801(a) of the Internal Revenue Code of 1954 defines a "life insurance company" as an insurance company whose life insurance reserves comprise more than 50 percent of its "total reserves," as that term is defined in Section 801(c).

The question presented is whether an insurance company which bears the ultimate insurance risk on accident and health insurance ceded to it by another company or ceded by it to the other company under reinsurance agreements is required for federal tax purposes to include in its total reserves the reserves attributable to such non-life policies so as to render it ineligible for preferential tax treatment as a life insurance company, or whether, as the Court of Claims held, such reserves are attributable to the other company which temporarily holds the premiums paid in advance on such policies.

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[1] The precise amount of the judgment will be determined in further proceedings under Rule 131(c) of the Court of Claims (App. B, *infra*, p. 129a).

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 801 [as amended by Sec. 2(a), Life Insurance Company Income Tax Act of 1959, P.L. 86-69, 73 Stat. 112). DEFINITION OF LIFE INSURANCE COMPANY.

(a) *Life Insurance Company Defined.*—For purposes of this subtitle, the term "life insurance company" means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance) or noncancellable contracts of health and accident insurance, if—

(1) its life insurance reserves (as defined in subsection (b)), plus

(2) unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, health, or accident policies not included in life insurance reserves,

comprise more than 50 percent of its total reserves as defined in subsection (c)).

(b) *Life Insurance Reserves Defined.*—

(1) *In general.*—For purposes of this part, the term "life insurance reserves" means amounts—

(A) which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and

(B) which are set aside to mature or liquidate, either by payment or reinsur-

ance, future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies.

* * * * *

(c) *Total Reserves Defined.*—For purposes of subsection (a), the term "total reserves" means—

(1) life insurance reserves,

(2) unearned premiums, and unpaid losses (whether or not ascertained), not included in life insurance reserves, and

(3) all other insurance reserves required by law.

The term "total reserves" does not include deficiency reserves (within the meaning of subsection (b)(4)).

* * * * *

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.801.3 *Definitions.*

* * * * *

(e) *Unearned premiums.* The term "unearned premiums" means those amounts which shall cover the cost of carrying the insurance risk for the period for which the premiums have been paid in advance. Such term includes all unearned premiums, whether or not required by law.

* * * * *

§ 1.801-5 *Total reserves.*

* * * * *

(b) *Reserves required by law defined.* For purposes of part I, subchapter L, chapter 1 of the Code, the term "reserves required by law" means reserves which are required either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute, and which are reported in the annual statement of the company and accepted by state regulatory authorities as held for the fulfillment of the claims of policyholders or beneficiaries.

* * * * *

STATEMENT

Respondent is a wholly-owned subsidiary of Southern Discount Company. At the time of respondent's incorporation in 1957 under the Insurance Code of Arizona, its parent, Southern Discount, was engaged in the consumer finance business in Georgia and several other states. At the time Southern Discount made a loan, its borrowers usually purchased term life and accident and health ("A&H") insurance in order to guarantee the payment of the loan in the event of the borrower's death or disability.

This type of insurance, known as credit life and credit A&H insurance, is generally coextensive in term and coverage with the term and amount of the

loan, and provides for the full payment of the loan in the event of the borrower's death or for the payment of monthly installments on the loan in the event of his disability resulting from accident or sickness. The premiums for such insurance are generally payable by the borrower in advance for the full period of coverage (App. B, *infra*, pp. 68a-69a, 94a-95a).

The Georgia law under which Southern Discount was incorporated prohibited it from issuing credit life and credit A&H insurance. However, it was permitted to act as a sales agent for qualified insurance companies issuing such policies. Prior to its formation of respondent, Southern Discount acted as a sales agent for American Bankers Life Assurance Company, which issued credit life and credit A&H policies to Southern Discount's debtors. Under its arrangement with American Bankers, Southern Discount received a commission of approximately 50 percent of the premiums paid by the policyholders, which was the maximum commission rate allowed by law (App. B, *infra*, p. 69a).

In order to obtain a greater portion of the profits from the credit insurance issued to its borrowers, Southern Discount organized respondent in 1957 for the purpose of underwriting the credit life and credit A&H insurance for its borrowers. Under Georgia law, respondent's initial $38,000 capitalization was insufficient to enable it to act as a direct insurer. However, because of its status as an insurance company chartered in Arizona, respondent was permitted to reinsure policies issued by companies authorized to

issue insurance directly. As a result, on June 28, 1957, respondent entered a reinsurance agreement or treaty ("Treaty I") with American Bankers under which it reinsured all credit life and credit A&H policies thereafter issued by American Bankers to the borrowers from Southern Discount and its subsidiaries (App. B, *infra*, pp. 69a-70a, 95a-99a).

Respondent freely conceded in the court below that it assumed the entire insurance risk under Treaty I on all credit life and credit A&H policies, in exchange for which it received 87½ percent (subsequently increased to 90½ percent) of all premiums collected by American Bankers on such policies. American Bankers collected the premiums in full when it issued the policies. Pursuant to Treaty I, American Bankers each month remitted to respondent its full share of all life insurance premiums received by it during the previous month. However, with respect to the credit A&H premiums, American Bankers remitted to respondent each month only that portion of the premiums collected during the prior month that was ratably allocable to the coverage for the prior month. The remaining portions of respondent's share of A&H premiums were remitted monthly on a pro rata basis over the balance of the term of the policy.

Thus, while respondent received its share of life insurance premiums almost immediately upon issuance of the policies, it received its share of the A&H premiums only after the periods of coverage attributable to the premiums had expired. The agreement further provided that respondent would maintain its reserves with respect to the life insurance and that

American Bankers would maintain reserves for "unearned premiums," representing the amount of A&H premiums attributable to the remaining unexpired portions of the terms of the policies (App. B, *infra*, pp. 70a-71a, 110a-117a).

By 1962, respondent's capital increased sufficiently to enable it to qualify as a direct insurer under Georgia and North Carolina law. Thereafter, respondent began to issue directly credit life and credit A&H policies to Southern Discount's borrowers. As a result of this change in respondent's status, on April 18, 1962, American Bankers and respondent entered into a new reinsurance agreement ("Treaty II"). Under Treaty II, respondent became the primary insurer of the credit life and A&H policies issued to Southern Discount's borrowers. American Bankers agreed in form to reinsure 80 percent of the A&H policies issued by respondent. However, American Bankers did not purport to reinsure any of the life insurance issued by respondent (App. B, *infra*, pp. 72a-73a, 99a).

Treaty II provided that respondent was to remit to American Bankers quarterly the premiums collected on the ceded A&H policies, less its own commission of 50 percent. The agreement further provided that American Bankers would return to respondent a quarterly rebate or "experience refund" equal to the total premiums ratably allocable to the insurance coverage for the quarter less the sum of: (1) respondent's 50 percent commission with respect to such "earned" premiums; (2) three percent of gross earned premiums allocable to such quarter;

and (3) the sum of all claims paid during the quarter by American Bankers as reinsurer on such policies. In the event the sum of these three reductions exceeded the earned premiums for any quarter, the excess would be carried over to the succeeding quarter and charged against the experience refund for that quarter (App. B, *infra*, pp. 72a-74a).

As of December 31, 1964, Treaty II was amended to provide that any negative carry-forward arising from loss experience for a particular quarter would be dropped after 20 quarters, in the event it was not absorbed by that time. The effect of this amendment was that American Bankers would be entitled to its 3 percent commission and would incur no insurance loss unless it experienced average claims on these policies exceeding 47 percent of premiums over a period of more than 20 consecutive quarters. Conversely, there were no circumstances under which American Bankers' profit under Treaty II could have exceeded its three percent commission. The loss experience on A&H policies under Treaty II had ranged from 28 to 30 percent of premiums paid. At the time of the 1964 amendment, the loss experience on A&H policies covered by Treaty II was only 18 percent of premiums paid [2] (App. B, *infra*, pp. 72a-74a, 99a-100a, 118a-128a; App. A, *infra*, p. 48a).

During the period 1958-1964, respondent reported

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[2] The trial judge found that the likelihood that loss experience would run so high as to jeopardize American Bankers' commission was so remote as to be negligible, and that the parties knew this to be the fact (App. A, *infra*, p. 48a).

on the annual statements it was required to file with the Arizona and Georgia insurance authorities that it received income from life insurance premiums. Accordingly, it reported the life insurance reserves for such policies prescribed by the appropriate actuarial tables. However, with respect to the A&H policies respondent reinsured with American Bankers under Treaty I, respondent reported as income only the portion of premiums paid to it by American Bankers, which was attributable to the expired portions of the terms of the policies.

Respondent did not report, either as income or as an asset, any of the A&H premiums attributable to the unexpired portions of the terms of the policies, and it reported no reserves with respect to the A&H policies. Similarly, respondent reported no reserves on the A&H policies ceded to American Bankers under Treaty II. American Bankers, on the other hand, maintained unearned premium reserves with respect to the A&H policies reinsured by respondent under Treaty I as well as the A&H policies ceded by respondent under Treaty II.

During 1958-1964, respondent was subjected to a number of examinations by the insurance departments of Arizona, Georgia and other states in which it did business, but its failure to maintain reserves with respect to the A&H coverage under Treaty I or II was never disapproved (App. B, *infra*, pp. 71a-72a, 74a-76a, 101a-102a, 105a-107a).

Respondent filed its federal income tax returns for the years 1958-1964 in accordance with its method of

reporting reserves on the annual statements filed with the various state insurance authorities. Respondent took the position on its tax returns that it qualified for the preferential tax treatment accorded to a "life insurance company" as defined by Section 801(a) of the Internal Revenue Code because its life insurance reserves exceeded 50 percent of its total reserves as it reported on its annual statements. On audit, the Commissioner of Internal Revenue determined that the reserves on the A&H policies under both Treaty I and II were includable in respondent's total reserves. When the A&H reserves were taken into account, respondent failed to qualify as a "life insurance company" under the Section 801(a) definition (App. B, *infra*, pp. 76a-77a, 92a-94a).

In this refund suit brought by respondent in the Court of Claims, the trial judge's recommended decision upheld the Commissioner's determination that respondent was required to include the reserves attributable to the A&H insurance as part of its total reserves so as to disqualify it as a "life insurance company" as defined by Section 801(a) of the Code. The trial judge premised his conclusion on the ground that with respect to both Treaty I and II, respondent was required by Georgia and Arizona law to maintain the reserves attributable to the A&H insurance so that such reserves were includable in respondent's total reserves as "other insurance reserves required by law" under Section 801(c)(3) of the Code. As a result, the trial judge found it unnecessary to decide whether respondent was required to include in

its total reserves the A&H reserves as "unearned premiums" under Section 801(c)(2) of the Code (App. A, *infra*, pp. 14a-23a).

With one judge dissenting, the Court of Claims disagreed with the recommended decision of the trial judge. In accordance with its decision of the same date in *Penn Security Life Insurance Co.* v. *United States*, 524 F.2d 1155, the majority held that the A&H reserves could not be included in respondent's total reserves as "unearned premiums" under Section 801(c)(2) of the Code because American Bankers was in physical possession of the unearned portion of the premiums paid in advance on the A&H policies under both Treaty I and II (App. B, *infra*, p. 81a). In rejecting the trial judge's conclusion that respondent was required by Georgia and Arizona law to include the A&H reserves in its total reserves, the majority relied upon the fact that respondent's method of reporting its income and reserves did not result in the institution of any action by the Georgia or Arizona insurance authorities (App. B, *infra*, pp. 81a-92a).

The dissenting judge adhered to the views expressed in his dissent in *Penn Security Life Insurance Co.* v. *United States*, *supra* (App. B, *infra*, p. 92a). He argued that the A&H reserves should be included in respondent's total reserves as "unearned premiums" under Section 801(c)(2) of the Code because "[respondent] has arranged to have [such reserves] ostensibly carried for it by others, though in reality it bears the risk of loss itself" (524 F.2d at 1167). In so concluding, the dissenting judge agreed with

the decision of the Seventh Circuit in *Economy Finance Corp.* v. *United States*, 501 F.2d 466, certiorari denied, 420 U.S. 947, which held, on facts essentially identical to those of Treaty I, that non-inclusion of such reserves "completely frustrates the purpose Congress ha[d] in mind in prescribing the [50 percent] test [of Section 801(a)]" (524 F.2d at 1167).

REASONS FOR GRANTING THE WRIT

1. As the Court of Claims recognized in its companion decision in *Penn Security Life Insurance Co.* v. *United States*, 524 F.2d 1155, 1161-1162, its holding there and in this case (see App. B, *infra*, p. 81a) directly conflicts with *Economy Finance Corp.* v. *United States*, 501 F.2d 466 (C.A. 7), certiorari denied, 420 U.S. 947, which was followed in *First Railroad & Bank Co. of Ga.* v. *United States*, 514 F.2d 675 (C.A. 5). See also *Superior Life Insurance Co.* v. *United States*, 462 F.2d 945 (C.A. 4). The decision below holding that an insurance company is not required to include in its total reserves those reserves attributable to non-life insurance on which it bears the ultimate insurance risk so that it may qualify for the preferential income tax treatment accorded to a "life insurance company" as defined in Section 801(a) of the Internal Revenue Code of 1954, is therefore in conflict with those of two courts of appeals. The issue has been and continues to be widely litigated, and resolution of the conflict by this Court is essential in order that there be a uniform national rule.

Moreover, the effect of the decision below upon the revenue is substantial. We are advised by the Internal Revenue Service that there are at present pending administratively 90 cases involving the issue with more than $28 million of taxes at stake. Since any insurance company may sue for a refund in the Court of Claims and invoke the authority of its decision in this case, the fiscal significance of the decision below potentially encompasses every pending case involving the issue. A decision with such far reaching impact upon the federal revenues involving the basic statutory definition of a "life insurance company" calls for review by this Court.

2. a. Under the Internal Revenue Code of 1954, life insurance companies enjoy tax treatment which is markedly more favorable than that of other types of insurance companies. Pursuant to Section 802 of the Code, a life insurance company is generally subject to a current tax only on (1) a prescribed portion of its investment income (Section 804); and (2) one-half of the amount by which its "gain from operations" (Section 809) exceeds its "taxable investment income."[3] On the other hand, other types of stock insurance companies, such as those engaged in the sale of cancellable accident and health insurance and other forms of casualty insurance, are gen-

[3] The structure and operation of the present statutory system for the taxation of life insurance companies are summarized in *United States* v. *Atlas Life Ins. Co.*, 381 U.S. 233, 235-238, and *Jefferson Standard Life Ins. Co.* v. *United States*, 408 F.2d 842, 844-846 (C.A. 4), certiorari denied, 396 U.S. 828.

erally taxable on their total annual net income. See Sections 831 and 832 of the Code.

Like respondent, many insurance companies do not deal exclusively in either life or non-life insurance but in a combination of the two types of policies. Accordingly, as early as Section 242 of the Revenue Act of 1921, c. 136, 42 Stat. 227, 261, Congress provided for an objective mathematical test designed to limit the preferential life insurance company tax treatment to those companies whose predominant business was the assumption of life insurance risks.[4] See, *e.g.*, *National Protective Ins. Co.* v. *Commissioner*, 128 F.2d 948, 950 (C.A. 8), certiorari denied, 317 U.S. 655; *New World Life Insurance Co.* v. *United States*, 26 F. Supp. 444, 461 (Ct. Cl.), affirmed on another issue, 311 U.S. 620; *Commissioner* v. *Monarch Life Ins. Co.*, 114 F.2d 314, 324-325 (C.A. 1).

The current statutory test is set forth in Section 801(a) of the 1954 Code, *supra*, p. 3, which defines

[4] As Dr. T. S. Adams of the Treasury Department explained to the Senate Finance Committee in 1921 (Hearings on H.R. 8245, Internal Revenue, before the Senate Committee on Finance, 67th Cong., 1st Sess. 85 (1921))—

> Some companies mix with their life business accident and health insurance. It is not practicable for all companies to disassociate those businesses so that we have assumed that if this accident and health business was more than 50 percent of their business, as measured by their reserves, it could not be treated as a life insurance company. On the other hand, if their accident and health insurance were incidental and represented less than 50 percent of their business we treated them as a life insurance company.

a "life insurance company" as an insurance company whose life insurance reserves plus its unearned premiums and unpaid losses on noncancellable life, health or accident policies comprise more than 50 percent of its total reserves. Section 801(c) in turn defines the term "total reserves" as consisting of: (1) life insurance reserves; (2) unearned premiums and unpaid losses not included in life insurance reserves; and (3) all other insurance reserves required by law.

b. The question presented in this case concerns respondent's eligibility as a "life insurance company" under Section 801(a) of the Code. During the taxable years at issue, respondent bore the ultimate insurance risk with respect to both life and non-life (A&H—accident and health) insurance under two successive reinsurance agreements (Treaty I and II) with another insurance company, American Bankers Life Assurance Company. The resolution of the question presented turns on whether the reserves attributable to the non-life policies are includable in respondent's total reserves or in American Bankers' total reserves. As the court below stated: "If those reserves are includable in [respondent's] total reserves, it concededly does not pass the 50 percent test of Section 801. If, as [respondent] says, they are chargeable to American Bankers rather than to itself, it does" (App. B, *infra*, p. 79a).[5]

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[5] Respondent does not contend that the accident and health policies were "noncancellable life, health, or accident policies" which would be eligible for inclusion in both the numerator and the denominator under the 50 percent test of Section 801(a)(2). Under the accident and health coverage in question, the insured did not have a guaranteed option to renew on the expiration of the initial term. Thus, it was not "noncancellable" within the meaning of the statute. See *Economy Finance Corp.* v. *United States*, *supra*, 501 F.2d at 480-482.

Here, the Court of Claims held that the A&H reserves were includable in American Bankers' total reserves under both reinsurance transactions to which respondent was a party. We submit, however, that a careful analysis of the economic substance of the Treaty I and II arrangements, which are typical of those used in the industry, decisively establishes that the A&H reserves under both treaties are includable in respondent's total reserves as "unearned premiums" under Section 801(c)(2).

Under Treaty I, respondent reinsured all of the credit life and A&H policies issued by American Bankers in exchange for 90½ percent of the premiums collected by American Bankers. But the court below recognized with respect to Treaty I that all life and A&H policies first issued by American Bankers "were to be fully reinsured with [respondent] which, as it freely concedes, thereby assumed the entire insurance risk represented by each of the policies involved; A&H as well as life" (App. B, *infra*, p. 70a). Since respondent and not American Bankers assumed the full risk under the A&H policies, those policies reflected its insurance business and not that of American Bankers, whose role was limited to that of a commission agent.

Simply put, the insurance reserves necessarily follow the insurance risk, as evidenced by respondent's retention of 90½ percent of the A&H premiums to meet the claims under the policies. Thus, the reserves necessary to meet the A&H insurance risk were properly includable in respondent's insurance reserves. Indeed, to conclude, as the Court of Claims did, that the A&H reserves were part of American Bankers' total reserves because that company temporarily held the "unearned" portions of the A&H premiums before ratably paying them to respondent is to exalt the form of the transaction over its economic substance by ignoring the fact that the final destination of the A&H premiums was respondent and not American Bankers. Cf. *Superior Life Insurance Co.* v. *United States, supra*, 462 F.2d at 950.

The fundamental error of the Court of Claims in holding that the A&H reserves were attributable to American Bankers was its assumption that that company held "unearned premiums" of the A&H policies in the sense that term is used in Section 801(c)(2). However, the term "unearned premiums" in the statute connotes an insurance company's maintenance of a reserve from premiums to meet the risk of claims it has assumed. But here American Bankers did not hold "unearned premiums" to meet any insurance risk it had assumed. To the contrary, it was holding such premiums under an obligation to pay them over to respondent, which had assumed the risk under the A&H policies throughout the term of their coverage.

Under these circumstances, American Bankers can-

not be deemed to possess a reserve under the A&H policies simply because it was temporarily holding the A&H premiums on behalf of respondent. As the Seventh Circuit stated in its contrary decision in *Economy Finance Corp.* v. *United States, supra*, in characterizing the role of a company analogous to American Bankers in an arrangement virtually identical to Treaty I: "[it] performed a banking and clearing house function and not an insurance function" (501 F.2d at 478). Like the ceding company in *Economy Finance*, American Bankers was exposed to no insurance risk under Treaty I. Pursuant to that arrangement, American Bankers cannot be deemed to have any insurance reserves. The A&H reserves must therefore be included in respondent's total reserves under Section 801(c)(2).

The foregoing observations are equally applicable to Treaty II. Under that more elaborate but economically equivalent arrangement, respondent directly issued the A&H policies and American Bankers purported to reinsure them. But in addition to respondent's initial retention of 50 percent of the A&H premiums as a commission, American Bankers was required to pay over to respondent 47 percent of the premiums after deduction of any claims paid. Moreover, pursuant to a loss carryover mechanism under Treaty II, American Bankers could incur no insurance loss unless it experienced average claims exceeding 47 percent of A&H premiums for more than five consecutive years. Since the loss experience under Treaty II ranged from 18 to 30 percent

of A&H premiums, the trial judge was amply justified in finding that the likelihood that American Bankers would be exposed to any insurance risk was so remote as to be negligible, and that the parties knew that to be the fact (App. A, *infra*, p. 48a).

In sum, as in the case of Treaty I, American Bankers' role under Treaty II did not constitute an insurance function but was limited to a banking and clearing house function of receiving premiums and disbursing payment for claims in exchange for a commission equal to no more than three percent of the premiums.[6] Thus, under Treaty II, American Bankers assumed no risk of insurance. That risk remained with respondent, which kept 97 percent of the A&H premiums to meet the claims under the policies.

Respondent can therefore no more avoid inclusion of the A&H reserves in its total reserves under Treaty II than it can under Treaty I. As the Fifth Circuit in *First Railroad & Bank Co. of Ga.* v. *United States, supra*, 514 F.2d at 677, correctly concluded in its contrary holding with respect to an arrangement identical to Treaty II: "Reinsurer under the arrangement did not bear any risks except the outside possibility of insolvency of Insurer. We hold therefore there was no substance to the agreement as reinsurance" (footnote omitted). The lack of substance to Treaty II as reinsurance likewise renders

[6] The court below acknowledged as much in stating: "* * * there were no circumstances under which American Bankers' return under Treaty II could exceed the 3 percent allotted to it therein" (App. B, *infra*, p. 74a).

respondent ineligible for "life insurance company" status during the years that latter arrangement was in force.[7]

[7] The fact that the Court of Claims also concluded (App. B, *infra*, pp. 81a-91a) that respondent was not required under Georgia or Arizona law to establish a reserve for the A&H policies does not weaken our argument that the economic reality of the reinsurance transactions is controlling for federal tax purposes under Section 801(c)(2). Indeed, in the life insurance area, this Court has repeatedly indicated that state insurance statutes or administrative practices do not determine the question whether certain reserves should be taken into account for federal tax purposes, even though they were required under state law. See, *e.g.*, *McCoach* v. *Insurance Co. of North America*, 244 U.S. 585, 589 (reserve for unpaid losses); *United States* v. *Boston Insurance Co.*, 269 U.S. 197 (loss claim reserves); *New York Life Ins. Co.* v. *Edwards*, 271 U.S. 109, 119 (reserve for unreported losses); *Helvering* v. *Illinois Ins. Co.*, 299 U.S. 88, 90-91 (reserve to meet obligation to provide a tontine fund). In the present context, "[t]he fact that the state insurance authorities required or permitted [American Bankers] to hold the reserve for solvency purposes does not answer the question of whose business the reserves measure." *Economy Finance Corp.* v. *United States, supra*, 501 F.2d at 478-479. As the Fifth Circuit similarly observed in *First Railroad & Bank Co. of Ga.* v. *United States, supra*, 514 F.2d at 677 n. 8: "The fact that the state insurance authorities permitted the 'reserves' to be handled as done by Insurer and Reinsurer cannot overcome these economic realities."

At all events, we submit that the Court of Claims erred in concluding that Georgia and Arizona law did not require respondent to establish a reserve for the A&H policies under both Treaty I and II. While the Court of Claims did not appear to refute the trial judge's analysis of the applicable state statutes (App. A, *infra*, pp. 15a-16a, 20a-23a), it premised its conclusion on the fact that neither the Georgia nor Arizona authorities took any action against respondent's

CONCLUSION

For the reasons stated, the petition for a writ of certiorari should be granted.

Respectfully submitted.

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FEBRUARY 1976.

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failure to establish such a reserve for state reporting purposes. But the Georgia chief examiner testified that respondent's failure to report in its annual statement any unearned premium reserve was permitted "unwittingly" by Georgia (Tr. 380) and was contrary to that state's policy (Tr. 335-337, 341-342, 353-359, 370, 380, 382, 385, 409-413). Similarly, the Arizona examiner who had conducted respondent's triennial examination for that state for 1963 also testified that it should have been required to maintain the unearned premium reserves under Treaty II, but had been permitted to take credit for the reserves because it was the first time that the Arizona insurance commissioner had encountered that situation (Tr. 423, 425-429).

Thus, the A&H reserves under both Treaty I and II would be includable in respondent's total reserves on the independent alternative ground that they were "other insurance reserves required by law" under Section 801(c)(3) of the Code. See also Treasury Regulations, Section 1.801-5(b).

APPENDIX A

IN THE UNITED STATES COURT OF CLAIMS
TRIAL DIVISION

No. 463-70

(Filed Dec. 13, 1974)

CONSUMER LIFE INSURANCE COMPANY

v.

THE UNITED STATES

E. Michael Masinter, attorney of record, for plaintiff. *James H. Landon* and *Hansell, Post, Brandon & Dorsey*, of counsel.

Herbert Grossman, with whom was *Assistant Attorney General Scott P. Crampton*, for defendant. *Gilbert E. Andrews*, of counsel.

OPINION *

WILLI, *Trial Judge*: This is a single issue tax refund suit that arises out of a small loan company's entry into the insurance business through a wholly owned subsidiary that it formed especially for that purpose. The question is whether that sub-

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* The trial judge's recommended decision and conclusion of law are submitted in accordance with Rule 134(h).

sidiary, the plaintiff in this proceeding, qualified for the discrete tax treatment accorded a "life insurance company" by the Internal Revenue Code.

The facts, which are basically uncontested, are fully detailed in the findings of fact accompanying this opinion and will be repeated herein only to the extent necessary to an understanding of the result reached.

In 1957 Southern Discount Company (Southern), a Georgia corporation, was operating a well established and successful consumer finance business. Its customer-borrowers typically purchased term life and accident and health (A & H) insurance at the time that they obtained their loans. The premium charge for the entire coverage involved was thereupon paid in full. The customers bought this protection, coextensive in both time and amount with the curtailment requirements of their borrowings, to provide a means of automatically servicing their debts to Southern in case of death or disability prior to full repayment. Georgia law prohibited Southern, as a loan company, from acting as an insurance underwriter with respect to such coverages. It was not forbidden, however, from functioning as a sales agent for insurance underwritten by a carrier duly qualified to conduct an insurance business in Georgia. American Bankers Life Insurance Company (American Bankers), a Florida corporation, was such a carrier.

Until 1957 Southern acted as a commission sales agent for American Bankers in respect to life and A & H insurance issued by the latter to Southern's

borrowers. Under this arrangement, Southern received the maximum commission rate allowed by law; amounting to approximately 50 percent of the policyholder premiums. Despite the attractiveness of that return, for which it apparently had to do little more than place American Bankers' policies with its own borrowers, Southern concluded that it could reap even greater profits from this source if it could participate as an underwriter rather than just a sales agent. It was that determination that prompted Southern to form the plaintiff as a wholly owned subsidiary.

Southern surveyed state law to locate the jurisdiction that had the most modest capitalization requirements for a licensed insurer and found that it was Arizona. Plaintiff was organized July 1, 1957 as an insurance company under an Arizona charter with an initial balance of invested capital and paid-in surplus of only $38,000. These resources were not sufficient to permit it to qualify as a direct insurer under Georgia law. It could, however, use its Arizona charter authority to operate as a reinsurer of Georgia and North Carolina coverages written by American Bankers—a duly authorized insurer in both of those states. American Bankers was willing to enter into a reinsurance treaty arrangement with plaintiff, under which it surrendered substantially all underwriting profit in return for a relatively minimal fixed fee, because it knew that if it refused, Southern would have no difficulty in replacing it with another qualified carrier. Thus,

its alternative was outright exclusion from the insurance business generated by Southern's borrowers. Thereupon, on June 28, 1957, American Bankers entered into the first of two consecutive insurance treaties (Treaty I and Treaty II, respectively), with the plaintiff.

Two premises are assumed for purposes of this decision; first, that insofar as germane to this case the relationship between plaintiff and American Bankers was arm's-length and, second, that while tax considerations no doubt were an influencing factor, there were business considerations underlying plaintiff's participation in the arrangements with American Bankers that are the subject of this suit. This is particularly true of the first of the two treaties to be discussed.

Under Treaty I, the entire text of which is set forth in finding 10, *infra*, all life and A & H policies issued by American Bankers to debtors of plaintiff's affiliates (including the parent, Southern), on and after July 1, 1957 were to be fully reinsured with plaintiff which, as it freely concedes, thereby assumed the entire insurance risk represented by each of the policies involved; A & H as well as life. As compensation for its reinsurance function, plaintiff was to receive 87½ percent (later increased to 90½ percent) of all premiums collected by American Bankers from the policyholders. The timing of these payments by American Bankers to plaintiff differed, however, as between life and A & H, although the agreement required monthly remittances in each in-

stance. As already noted, American Bankers collected all premiums in full at the inception of coverage. The Treaty stipulated that as to life policies, American Bankers was, at the end of each month, to pay plaintiff its entire share of all life premiums collected from policyholders during that month. As to A & H, however, American Bankers was to pay plaintiff only the portion of its total share of premium receipts during that month that was ratably allocable to that month's coverage; the agreement being to pay over the remainder monthly on a pro rata basis spread over the balance of the coverage period. Thus, in respect to A & H, plaintiff never actually held any premium dollars attributable to a future period of coverage and risk exposure.

Finally, Treaty I provided for termination by either party upon thirty days' written notice to the other. Termination was to be wholly prospective, the relevant clause specifying: "Upon termination by either party, this agreement shall continue to apply to all policies reinsured hereunder before such termination becomes effective." Finding 10, *infra*.

As required by state law, plaintiff filed annual reports of its activities under Treaty I with the insurance regulatory authorities in Arizona and Georgia. On those reports it characterized its life and A & H dealings differently. It did so by reporting both premium income and related reserves solely on the basis of actual dollar receipts for the year involved. This meant that for the life coverages it declared as premium income its entire percentage

share of the premiums paid by policyholders during that year. Consonantly, it reported the full tabular reserve for all of such policies. As to A & H, however, it limited reported premium income to the annual aggregate of the incremental payments that had been received monthly from American Bankers. Moreover, it showed nothing on the asset side of the report representing the premiums on existing A & H policies that it was entitled under the Treaty to receive in the future. With premium income and asset balances thus restricted, plaintiff reported no reserves whatever in respect to the A & H coverages that it reinsured under Treaty I. As to those coverages, American Bankers included on its own annual reports an unearned premium reserve based on the amount of A & H premiums collected from policyholders but not yet paid over to the plaintiff. Finding 15, *infra*. Neither the Georgia nor the Arizona regulatory authorities ever challenged or disapproved the method by which plaintiff reported its A & H reinsurance activities under Treaty I. Finding 16, *infra*.

By 1962 plaintiff had accumulated enough earnings from operations under Treaty I to enable it to qualify as a direct insurer under Georgia and North Carolina law. It thereupon applied for and received such authority from the State of Georgia. From then on plaintiff operated as the issuing company on all life and A & H policies sold to the loan customers of Southern and its affiliates. Treaty I, in which plaintiff's role was solely that of a reinsurer,

was consequently no longer suited to its purposes. Accordingly, effective March 1, 1962, plaintiff and American Bankers entered into a new insurance treaty under which their roles were reversed; plaintiff functioning as the issuing or ceding carrier and American Bankers denominated the "reinsurer".

Treaty II, the text of which is set forth in full at finding 17, *infra*, applied only to A & H insurance; plaintiff having determined to underwrite all future life insurance by itself. The Treaty provided that plaintiff, as the issuing or ceding company, would reinsure 80 percent of all future A & H policies with American Bankers. To that extent, plaintiff was to pay over to American Bankers on a quarterly basis all of the premiums collected from policyholders, American Bankers to return 50 percent of such amounts to the plaintiff as commissions. The Treaty contained a clause, entitled Experience Refunds, establishing a quarterly rebate due plaintiff in the amount of the total premium dollars ratably allocable to the expired portion of the term of policies for which such premiums had been collected, less the following deductions: (a) the amount of commissions paid plaintiff that was proportionate to the expired portion of the term of policies on which such commissions had been paid; (b) 3 percent of the earned premium dollars previously described; and (c) the sum of all claim payments made to plaintiff during the quarter by American Bankers as reinsurer. For all practical purposes, this clause served to fix American Bankers' stake in the undertaking

at a flat 3 percent of the premium dollars that it initially received from the plaintiff. Only if loss experience under the reinsured coverages exceed 97 percent of premiums would American Bankers' 3 percent return be encroached. Moreover, such a pattern of adverse experience would have had to persist for the ensuing twenty consecutive quarters before such an encroachment became permanent. Loss experience on A & H policies under Treaty I had ranged from 28 to 30 percent. Finally, there were no circumstances under which American Bankers' return under Treaty II could exceed the 3 percent allotted to it therein.

On its annual reports to the state regulatory authorities covering 1962 and subsequent years, plaintiff declared no reserves relative to that portion of the A & H policies covered by the reinsurance language of Treaty II. Again, no state regulatory authority took exception to this aspect of plaintiff's reports.

For each of the years 1958 through 1964 plaintiff computed its federal income tax liabilities and filed its returns on the premise that it was taxable as a "life insurance company" within the meaning of that term as defined by Section 801 of the Internal Revenue Code of 1954. On audit, the Revenue Service determined that plaintiff did not qualify as a life insurance company entitled to the preferential tax treatment accorded such an entity [1] and assessed de-

[1] *Economy Finance Corp.* v. *United States*, 501 F.2d 466, 474 (7th Cir. 1974), presents a succinct and lucid exposition of the policy considerations justifying special tax treatment for life insurance companies.

ficiencies accordingly (except for 1961 in which additional liability was fully expunged by other adjustments not in dispute). Plaintiff paid the assessments and upon formal disallowance of its seasonably filed claims for refund, brought this action, in which the sole question for decision is that concerning plaintiff's qualification as a life insurance company for federal tax purposes in the years 1958, 1959, 1960, 1962, 1963 and 1964.

As pertinent here, Section 801 defines a life insurance company as follows:

> SEC. 801 [as amended by Sec. 2, Life Insurance Company Income Tax Act of 1959, P.L. 86-69, 73 Stat. 112]. DEFINITION OF LIFE INSURANCE COMPANY.
>
> (a) *Life Insurance Company Defined.*—For purposes of this subtitle, the term "life insurance company" means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance), or noncancellable contracts of health and accident insurance, if—
>
> (1) its life insurance reserves (as defined in subsection (b)), plus
>
> (2) unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, health, or accident policies not included in life insurance reserves,

comprise more than 50 percent of its total reserves (as defined in subsection (c)).

* * * *

(c) *Total Reserves Defined.*—For purposes of subsection (a), the term "total reserves" means—

(1) life insurance reserves,

(2) unearned premiums, and unpaid losses (whether or not ascertained), not included in life insurance reserves, and

(3) all other insurance reserves required by law.

The term "total reserves" does not include deficiency reserves (within the meaning of subsection (b)(4)).

* * * *

Life insurance company status, it is seen, is made to depend solely on the character and composition of an insurance company's reserves. An insurance company merits life insurance company tax treatment if its life reserves amount to half or more of its total insurance reserves. Section 801(c) expressly directs that total reserves, the denominator portion of the fractional test, shall include three separate categories: (1) life reserves; (2) reserves for unearned premiums and for certain unpaid losses (the latter element not being involved in this suit); and (3) all other reserves required by law.[2]

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[2] The last-mentioned category has been traditionally and centrally implicated in the federal taxation of insurance companies. *See Brown* v. *Helvering*, 291 U.S. 192, 201 (1934), and cases cited therein.

Sections 1.801-3(e) and 1.801-5(b) of the Treasury Regulations on Income Tax (1954), endorsed by both parties to the present controversy, define unearned premium reserves and reserves required by law, respectively, as follows:

Unearned premiums. The term "unearned premiums" means those amounts which shall cover the cost of carrying the insurance risk for the period for which the premiums have been paid in advance. Such term includes all unearned premiums, whether or not required by law.

* * * *

Reserves required by law defined. For purposes of part I, subchapter L, chapter 1 of the Code, the term "reserves required by law" means reserves which are required either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute, and which are reported in the annual statement of the company and accepted by state regulatory authorities as held for the fulfillment of the claims of policyholders or beneficiaries.

In this case there is no disagreement as to either the fact or the particular amount of plaintiff's life insurance reserves for each of the years in suit. Its qualification depends entirely on the question of its chargeability with reserves incident to the A & H policies to which it was a party under Treaties I and II; there being no dispute that reserves must be maintained by someone in respect to those policies.

If those reserves are includable in plaintiff's total reserves, it concededly does not pass the 50-percent test of Section 801. If, as plaintiff says, they are chargeable to American Bankers rather than to itself, it does.

The cornerstone of plaintiff's position herein is its unduly restricted conception of the reserve criteria of Section 801. In effect, its approach reads out of the statute that portion of it [Section 801(c)(3)] specifying that "total reserves", for purposes of the fractional test, shall include "all other insurance reserves required by law". It consequently characterizes the issue to be decided solely in terms of whether it was obliged to maintain a reserve for unearned premiums, within the meaning of Section 801 (c)(2), in respect to the A & H policies covered by two Treaties.[3] In fairness, it should be noted that in earlier litigation with others, litigation that produced precedents that plaintiff urges should control this case, the Government's apprehension of the issue was apparently as limited as plaintiff says that it should be here. That background could understandably have encouraged plaintiff to adopt its present litigating perspective. Nonetheless, while it is

[3] On brief, plaintiff posits the question presented, as follows:

> May the Commissioner of Internal Revenue require plaintiff to include, for purposes of measuring plaintiff's reserves for purposes of qualification as a life insurance company, under the Internal Revenue Code, premiums, or reserves based on those premiums, held by an unrelated party pursuant to the terms of reinsurance treaties entered into for valid business reasons?

true that the Government's presentation herein is largely addressed to the issue as framed by the plaintiff, the presentation does include the supplementary contention that plaintiff was chargeable with A & H reserves, whether or not cast in the mold of unearned premiums, because such were required of it by state law.

To dispel the notion that it was required to maintain A & H reserves of a type comprehended by Section 801, plaintiff relies on (1) the language of the two insurance treaties under which it operated with American Bankers; (2) the testimony of a well-traveled actuarial expert, Arthur Crooks Eddy; (3) the fact that the state insurance regulatory personnel tacitly approved plaintiff's annual report forms showing no A & H reserves; and (4) the trial court's opinion in *Economy Finance Corp.* v. *United States*, 30 AFTR 2d 72-5446 (S.D. Ind. July 25, 1972), and this court's trial judge's opinion in *Penn Security Life Ins. Co.* v. *United States* (Ct. Cl. No. 109-68, decided March 2, 1973).

Simpliciter, the argument is that plaintiff was chargeable with no A & H unearned premium reserves because under both of the Treaties it received premium dollars only after the period of exposure to which those dollars related had expired. Accordingly, plaintiff says, since all the premiums that it received were, in point of time, already "earned" when it got them, there was no occasion for it to maintain a reserve for "unearned" premiums. Testifying as plaintiff's expert, Mr. Eddy

repeatedly opined that this feature of the Treaties, governing custody of prepaid premium dollars, was dispositive of the participants' respective reserve obligations, *i.e.*, that since it was American Bankers that physically held all of the A & H premium dollars allocable to the unexpired portion of the terms of the underlying policies, it was American Bankers, not plaintiff that was obligated to carry the reserves for those policies. In this regard, his testimony was the same as it apparently had been in *Economy Finance, supra,* and *Penn Security, supra.* At least in the latter case, if not the former as well, the relevant particulars of the factual situations involved were virtually identical to those presented by Treaty I. Certainly in the present case and seemingly in neither of his appearances in the earlier ones did Mr. Eddy undertake to canvass or discuss the particular provisions of applicable state law governing an insurer's reserve obligations—this even though he was testifying throughout in the context of a revenue statute that in part expressly relates such obligations to the requirements of state law.

It is unnecessary to decide specifically whether plaintiff was chargeable with any A & H unearned premium reserves covered by Section 801(c)(2) because however that might be, it was clearly required by state law to maintain reserves, cognizable by Section 801(c)(3), for the A & H policies to which it was a party under each of the Treaties.

As earlier noted, plaintiff freely acknowledges that it ultimately bore the entire insurance risk under Treaty I.

Section 56-908 of the Georgia Code Annotated, reproduced in full in finding 26, *infra,* expressly requires that: "For all accident and sickness policies the insurer shall maintain an active life reserve which shall place a sound value on its liabilities under such policies * * *." To the degree that risk exposure is the hallmark of an insurer, this provision squarely imposes a reserve obligation on plaintiff with respect to the A & H liabilities concededly assumed by it under Treaty I. While there are other and more compelling statutory reserve requirements, it may be noted that both Section 56-906 of the Georgia Code Annotated, finding 26, *infra,* and Section 20-506 of the Arizona Revised Statutes, finding 27, *infra,* employing generally similar language, require an "insurer" of coverages such as A & H maintain an unearned premium reserve in an indicated amount. It would seem that as the bearer of the ultimate policy risk exposure under Treaty I, plaintiff was an "insurer" within the contemplation of those provisions and was not the less so simply because it voluntarily elected to accept premiums piecemeal rather than in gross at the inception of coverage.

Finally, and whatever the case as to unearned premium reserves, an additional and important feature of state law applicable here plainly required

plaintiff to maintain A & H reserves in respect to Treaty I operations.

The express language of Treaty I, including that dealing with termination, vested plaintiff with an absolute right to receive, albeit in incremental installments, its full share (ultimately 90.5 percent) of all premiums collected from A & H policyholders whose coverages once became subject to the Treaty. Findings 10 and 13, *infra*. Mr. Eddy acknowledged at the trial that an insurer legally entitled to receive premiums in the future with respect to existing coverages is obliged to reflect such a right as an asset, in the nature of a receivable, on its reports to cognizant state regulatory authorities. He further recognized that such an asset gives rise to a concomitant liability in the nature of a reserve relating to the underlying exposure assumed in conjunction with and in consideration of the right to receive premiums in the future on the subject coverages. The laws of both Georgia and Arizona, findings 26 and 27, *infra*, bear out Mr. Eddy's testimony in this respect. Consequently, on the basis of the unambiguous language of Treaty I and the uncontradicted testimony of plaintiff's expert, both considered in the light of applicable state law, plaintiff was definitely obliged to maintain reserves in respect to the A & H policies to which it was a party under Treaty I. This is so whether or not such reserves are conceptually accommodated by Code Section 801(c)(2), speaking to "unearned premiums".

Plaintiff's reliance on *Penn Security Life Ins. Co.* v. *United States*, *supra*, as commending a contrary result is not well-taken.

An examination of the pertinent findings of fact in that case discloses that the plaintiff there, a Missouri corporation, was situated in circumstances factually identical to the present plaintiff operating under Treaty I. Finding 28, *infra*. There, as here, the plaintiff, as a reinsurer, was committed by express treaty provision to assumption of the entire insurance risk on all A & H policies subject to it and was, in turn, guaranteed the right to receive, on a deferred, incremental basis, its entire share of premiums collected from policyholders on A & H coverages in force at any time that the treaty was terminated. In short, the plaintiff in *Penn Security* had the same enforceable right to receive premium monies in the future as did the present plaintiff under Treaty I. Although Arthur Crooks Eddy testified as the plaintiff's expert in *Penn Security*, *supra*, his testimony did not include the acknowledgment that it did in the instant case, *viz*, that an insurer with an enforceable right to receive premiums in the future is obliged by state law to show the value of that right on the asset side of its annual report and to concurrently establish a related reserve reflecting the future insurance risk exposure in consideration of which it is entitled to receive such premiums.

Additionally, the court, in *Penn Security*, *supra*, was apparently not given the benefit, by Mr. Eddy or anyone else, of an exposition of the provisions

of state law affecting insurers' reserve responsibilities. Thus, the court found (finding 28, *infra*):

> * * * [*T*]*he mere fact that the ceding companies obtained reinsurance from plaintiff* under these treaties *did not affect their responsibility,* under state law or under actuarial principles, *to set up an unearned premium reserve* to reflect the unearned premiums actually held by those companies *on policies covered by reinsurance* treaties with plaintiff. * * * [Emphasis added]

VERNON'S ANNOTATED MISSOURI STATUTES provide in relevant part (finding 30, *infra*):

> 376.410. *Insurance companies to maintain reserves—exemptions*
>
> Except as provided in subdivision (6) of this section, all companies organized under the laws of this state, and engaged in writing policies of accident or health insurance, or combination policies of accident and health insurance, and all other companies transacting such kinds of business in this state, shall maintain reserves thereon in accordance with the following requirements:
>
> * * * *
>
> (4) In the calculation of reserves required to be maintained under this section, *proper credit shall be allowed for reinsurance in other companies* licensed to do business in this state; [Emphasis added]
>
> * * * *

For the various foregoing reasons, *Penn Security, supra,* really furnishes no support for the result urged by plaintiff under Treaty I.

The other precedent on which plaintiff relies, *Economy Finance Corp.* v. *United States,* 30 AFTR 2d 72-5446 (S.D. Ind. 1972), involved the reserve responsibilities of an A & H reinsurer that received premium remittances from a ceding carrier on an "as earned" basis similar to that involved here. The comparability to Treaty I of the treaty there involved is not nearly so clear as in the *Penn Security* situation.

It suffices for present purposes to note that the trial court's decision was reversed on appeal, albeit by a divided court. *Economy Finance Corp.* v. *United States,* 501 F.2d 466 (7th Cir. 1974). The dissent in that case[4] suggests that the majority reached its conclusion by applying a qualification test not authorized by Section 801 of the Revenue Code. Whatever the case in that regard, clarity requires an affirmative acknowledgment that the issue apprehended for purposes of the present opinion differs from that addressed by the majority in *Economy Finance, supra,* to wit (at 471):

> * * * The issue raised by the government is *not whether taxpayers should actually have established H & A reserves* but how such reserves should be considered for the limited purpose of determining taxpayers' qualifying ratio. This is not a question of form over substance but rather

[4] 501 F.2d at 483-86.

one of the proper characterization of the substance. [Emphasis added]

The issue decided herein is precisely that of whether the plaintiff, operating under Treaty I, *should actually have established A & H reserves.* Section 1.801-5(b) of the applicable Treasury Regulations, *supra*, permits no lesser standard where the inquiry is, as here, whether a reserve is comprehended by Code Section 801(c)(3). The evidence presented in this record, including the testimony of plaintiff's own expert, conclusively demonstrates that more than one facet of applicable state law required that *plaintiff should actually have done so.* To invalidate that conclusion requires much more than an implication based on the bare fact of the state regulatory authorities' failure to affirmatively challenge plaintiff's omission of A & H reserves from its annual reports covering Treaty I years. Exculpatory possibilities accounting for such unexplained inaction are limited only by the fertility of one's imagination. Moreover, in this instance the Treasury Regulation [5] defining "reserves required by law" for purposes of Code Section 801—a regulation to which plaintiff unreservedly subscribes on brief—notably casts state statutory provisions and administrative practice relative thereto in disjunctive, not conjunctive terms.

That plaintiff was chargeable by state law with A & H reserves under its Treaty II activities follows from a much simpler analysis than required for

[5] Treasury Regulations, Section 1.801-5(b).

Treaty I. Those A & H policies, unlike the coverages subject to the earlier Treaty, were issued by the plaintiff to the individual policyholders from whom it concurrently collected the full amount of the underlying premiums. It was, then, in the first instance the "insurer" of those policies, as that term is used in the relevant Georgia insurance statutes. Finding 26, *infra.* As such, it was subject at the outset to the reserve obligations imposed on insurers by Sections 56-905 and 56-908 of the Georgia Code Annotated, *supra.* Plaintiff's initial status as the insurer of all A & H policies issued by it was simply unaffected by Treaty II.

The essence of insurance is risk-shifting and risk distribution. *Helvering* v. *LeGierse*, 312 U.S. 531, 539 (1941). Reinsurance, which has a settled and traditionally understood meaning,[6] is insurance by the first insurer of the whole or some part of his interest in the risk created by his original contract of insurance. Treaty II effected no reinsurance because under it American Bankers assumed no part of the risk represented by the A & H policies issued by the plaintiff.

By virtue of the provisions of Articles I, II, IV and XIII, and particularly those of Article VI dealing with Experience Refunds, plaintiff retained the entire insurance risk under all of the A & H policies covered by Treaty II. Finding 17, *infra.* Because

[6] *Allemannia Fire Ins. Co.* v. *Firemen's Ins. Co.*, 209 U.S. 326 (1908).

of Article VI, American Bankers' pecuniary interest in Treaty II, aside from an investment return on premiums temporarily held, was fixed at 3 percent of the A & H premiums covered by the Treaty, without regard to loss experience. Only if losses under the subject policies exceeded 97 percent of premium income could American Bankers' receipt of its 3 percent participation be delayed to a subsequent quarterly period. The likelihood that loss experience would run as high as 97 percent was so remote as to be negligible and the parties knew this in advance on the basis of extensive prior experience with similar coverages. Finding 20, *infra*. Under these circumstances, American Bankers had no insurance role under Treaty II. Instead, it functioned essentially as a fixed-fee supplier of clerical services and a temporary, albeit beneficial custodian of premium monies that it was contractually obligated to return to the plaintiff on what amounted to a predetermined schedule. Its returns for these undertakings were substantially unaffected by the insurance risk appurtenant to the policies with which it was concerned. That the plaintiff voluntarily elected to relinquish control over A & H premiums, subject to a contractual right to fully regain them in incremental installments over a period of time, made it no less the real insurer of the risk represented by the policies to which those premiums pertained. The state authorities' acceptance of plaintiff's Treaty II-era annual reports showing no A & H reserves for the exposures on which American Bankers was

a nominal reinsurer is of no greater substantive consequence than their similar conduct in respect to Treaty I reports, as previously discussed.

Since plaintiff was required by law to maintain reserves with respect to the A & H policies covered by both Treaties I and II, it failed the fractional reserve test of Section 801 for tax treatment as a life insurance company. It therefore must be denied recovery.

FINDINGS OF FACT

1. Plaintiff was incorporated in Arizona on June 26, 1957 as a stock insurance company under the insurance code of that state. Its Articles of Incorporation authorized the following activities:

> (a) To insure, in its own proper and corporate name, the lives of persons and all insurance appertaining thereto, including, but not limiting the generality of the foregoing: term, industrial, retirement income, ordinary, modified, single premium, limited payment, group and all other types and forms of contracts of insurance upon or relating to the lives of persons in connection with the extension of credit to such persons.
>
> (b) To reinsure all or a part of any risk, class of risks, or all of the risks of the Company with any other insurance company or companies, and to accept such reinsurance from any other insurance company or companies, as allowed by law.

2. Plaintiff's outstanding stock has been owned throughout by Southern Discount Company (South-

ern) which, at all times pertinent hereto, was a Georgia corporation licensed under the consumer finance laws of the states in which it operated, to conduct a consumer finance business.

3. Credit life and accident and health insurance are sold in connection with a loan of money or an installment sale of tangible personal property. Credit life insurance, generally defined, is term insurance on the lives of debtors, with their creditors as beneficiaries, in amounts at least sufficient to discharge their indebtedness in case of death. The life coverage is frequently combined with accident and health coverage. The latter type pays the debtor's monthly installments during the period within the policy term in which he is totally disabled (*i.e.*, unable to work) because of accident or sickness, provided that the disability lasts beyond a minimum or "waiting" period. Coverage may be conditioned upon the permanent as well as total disability of the debtor. When life and accident and health coverage are provided in one contract, the respective premiums are separately stated. Premiums under both types of policy are collected in full from the insured at the inception of coverage.

4. Southern formed plaintiff because under the laws of Georgia and those of the other states in which it operated it was prohibited from acting as an insurance company. It was permitted, however, to act as an agent for authorized insurance companies and prior to plaintiff's formation it did so on behalf of various such companies, principally Amer-

ican Bankers Life Insurance Company (American Bankers), in respect to life and accident and health (A & H) policies sold to Southern's borrowers.

5. Acting as "sales agent" Southern received a commission of forty percent of premiums in North Carolina and fifty percent of premiums in Georgia, the maxima permitted by the laws of those jurisdictions. It was in order to obtain a greater proportion of the total profit on insurance sold to its borrowers that Southern formed the plaintiff. American Bankers was willing to permit Southern, through its plaintiff subsidiary, to realize a greater portion of the total profit obtained from insuring its debtors because it (American Bankers) realized that if it did not participate in an arrangement providing that result its alternative was total exclusion from the undertaking with a consequent loss of any profit participation at all. In short, American Bankers preferred half a loaf to nothing at all.

6. American Bankers is an insurance company licensed to engage in the life and disability insurance business under the laws of the State of Florida.

7. Other than as a party to certain treaties described more particularly below, American Bankers was totally unrelated to plaintiff at its inception and has remained an unrelated company except for its ownership of a nominal amount of stock (approximately 2½ percent) in plaintiff's parent, Southern Discount, from March 15, 1962 until March 25, 1969, and approximately 1 percent acquired in 1972 and disposed of in the following year.

8. Each of the states has its own minimum capitalization requirements for one seeking charter authority to conduct an insurance business. Arizona has the most moderate of such requirements. Thus, Southern qualified plaintiff under Arizona law, intending that it operate initially thereunder as a reinsurer, and was able to do so with an initial balance of invested capital and paid-in surplus of only $38,000.

9. Immediately following its formation plaintiff entered into an agreement (Treaty I) with American Bankers governing all future life and accident and health policies issued in respect to debtors of plaintiff's parent, Southern, and any of its other subsidiaries and affiliates.

10. Insofar as pertinent to this litigation, Treaty I provided:

ARTICLE I

American Bankers agrees to cede to *Consumer Life* and *Consumer Life* agrees to accept reinsurance to the extent set forth below:

One Hundred Per Cent (100%) of each and every Life policy and each and every Health and Accident policy (herein called "Life policies" and "Health and Accident policies") issued by American Bankers in respect to debtors of *Consumer Life* and its subsidiary and affiliated corporations. The liability of *Consumer Life* under said Life and Health and Accident policies shall follow the liability of American Bankers except that the liability of *Consumer Life* arising under its

reinsurance of said Health and Accident policies is on a month to month basis only and is limited solely to such amounts as shall become payable by *Consumer Life* under the provisions of Article V prior to the termination of this agreement.

ARTICLE II

This agreement applies to all said policies issued by American Bankers on or after the *1st* day of *July*, 1957.

ARTICLE III

American Bankers shall furnish *Consumer Life* on or before the 20th day of *July*, 1957 and on or before the 20th day of each month thereafter, a statement showing the following information on transactions of the preceding month:

A. On all Life policies the statement will show:

(1) The amount of premiums collected;
(2) The amount of premiums returned on account of cancellation or other reason; and
(3) The amount of losses paid.

B. On all Health and Accident policies the statement will show:

(1) The amount of premiums collected;
(2) The amount of premiums returned on account of cancellation or other reason;
(3) The amount of losses paid;

(4) The amount of losses reported and unpaid and the estimated amount of losses incurred and unreported at the end of the preceding month; and
(5) The amount of premiums earned.

For the purpose of computing premiums earned during any month on Health and Accident policies under this Article III, the sum of the premiums collected on policies written during the month less any premium returned because of cancellation or other reason during the month, shall be added to the unearned premium reserve at the beginning of the month on policies then in force, and from the total sum so obtained shall be subtracted the unearned premium reserve at the end of the month on policies in force at that time.

For the purpose of computing losses, losses reported and unpaid and losses incurred and unreported, the allocated loss expense shall be added to the amount of loss claims. In this connection the allocated loss expense shall be all claim expenses over and above the usual claim expenses incurred in the routine handling of a claim in the ordinary course of business, it being the intent of the parties hereto to include such expenses as the hiring of a special investigator, unusual travel expense in connection with the handling of a claim, attorney's fees arising from a claim and other expenses not incurred in the usual and ordinary course of handling a claim.

ARTICLE IV

In addition to the monthly statement set forth in Article III, American Bankers agrees to furnish *Consumer Life* on or before the 20th day of January each year and from time to time as may be requested by *Consumer Life*, but in no event more often than monthly, a statement containing the following information as at the end of the month preceding the statement:

A. The amount of reserve on all life policies then in force;

B. The amount of losses on Life policies reported and unpaid and the estimated amount of losses incurred but unreported;

C. The amounts of insurance on all Life policies;

D. Such other information as may be required to complete annual statements or other statements as required by law.

Consumer Life shall, at all reasonable times during this agreement, have full and free access to all books, records and files of American Bankers' office with respect to the business covered by this agreement.

ARTICLE V

In consideration of the reinsurance as set forth in Article I, the American Bankers agrees to pay monthly to *Consumer Life*, based on the statement set forth in Article III for the preceding month, and payable at the same time: (1) Eighty-seven and One-half Per Cent (87½%)

of the premiums collected less any premiums returned on all Life policies, and (2) Eighty-seven and One-half Per Cent (87½%) of the premiums earned on all Health and Accident policies.

Consumer Life agrees to reimburse American Bankers before the 30th day of the month after such statement is submitted, for all losses actually paid during the preceding month on Life policies and all losses actually paid during the preceding month on Health and Accident policies plus any increase or less any decrease during said month in the amount of Health and Accident losses reported and unpaid and incurred and unreported.

ARTICLE VI

American Bankers shall maintain all unearned premiums, loss and other reserves as may be required by law against all Health and Accident policies. *Consumer Life* shall maintain policy and other reserves as may be required by law on all Life policies.

ARTICLE VII

American Bankers agrees to pay all state, county, or city taxes which may be or become due in connection with the insurance sold or premiums collected on policies reinsured under this agreement.

ARTICLE VIII

American Bankers has furnished to *Consumer Life* and *Consumer Life* has acknowledged having received from American Bankers specimen forms upon which all said policies covered hereby are currently written. American Bankers reserves the right to make changes in such forms from time to time, but shall promptly notify *Consumer Life* of all such changes.

ARTICLE IX

The supervision and payment of all claims on policies covered by this agreement shall be handled by American Bankers and the decision of American Bankers in settling, rejecting or defending such claims shall be binding on *Consumer Life*.

ARTICLE X

In the event of the insolvency of the American Bankers, all reinsurance shall be payable directly to the liquidator, receiver or statutory successor of said American Bankers, without diminution because of the insolvency of American Bankers.

In the event of insolvency of American Bankers, the liquidator, receiver or statutory successor shall give *Consumer Life* written notice of the pendency of a claim on the policy reinsured within a reasonable time after such claim is filed in the insolvency proceeding. During the pendency of any such claim, *Consumer Life* may investigate such claim and interpose in the name of American Bankers (its liquidator, receiver or statutory successor,) but at its own expense, in the proceeding where such claims are to be adjudicated, any defense or defenses which *Consumer Life* may deem available to American

Bankers or its liquidator, receiver or statutory successor.

ARTICLE XI

All disputes and differences between the two contracting parties upon which an amicable understanding cannot be reached are to be decided by arbitration and the arbitrators, who shall regard this agreement from the standpoint of practical business and equity rather than from that of the strict law, are empowered to determine as to the interpretation of the agreement obligation.

The court of arbitrators which is to be held in the city of Miami, Florida, shall consist of three arbitrators who must be officers of life insurance companies other than the two parties of this agreement. One of the arbitrators is to be appointed by American Bankers, the second by *Consumer Life* and the third is to be selected by these two representatives before the beginning of the arbitration. Should one of the parties decline to appoint an arbitrator or should the two arbitrators be unable to agree upon the choice of a third, the appointment shall be left to the president of the American Life Convention.

The arbitrators are not bound by any rules of law. They shall decide by a majority of votes and from their written decision there can be no appeal. The cost of arbitration, including the fees of the arbitrators, shall be borne by the losing party unless the arbitrators shall decide otherwise.

ARTICLE XII

This agreement constitutes the entire contract between the parties and may not be altered, modified or in any ways amended except by an instrument in writing duly executed by the proper official of both parties.

ARTICLE XIII

This agreement may be terminated by either party effective on the last day of any month upon at least thirty (30) days written notice of the other party.

Upon termination by either party, this agreement shall continue to apply to all policies reinsured hereunder before such termination becomes effective.

IN WITNESS WHEREOF, the parties hereto have caused this instrument to be signed and sealed by their duly authorized officers on this *28* day of *June*, 1957.

11. By amendments effective November 1, 1957 and April 1, 1958, American Bankers' retained share of the total premiums received annually in excess of $200,000 was reduced from 12½ percent, as provided in Article V of Treaty I, finding 10, *supra*, to 9½ percent.

12. Treaty I was further amended May 28, 1958, effective as of July 1, 1957, to revise the extent of plaintiff's interim liability as the reinsurer of American Bankers' exposure under the A & H coverages subject to the Treaty. At all times, however, plaintiff

reinsured the entire risk represented by those coverages, the only change being in the timing of its loss indemnity payments to American Bankers. At the time of this amendment plaintiff had accumulated a surplus fund of $130,000 from A & H premium receipts out of which to meet its reinsurance obligations which were averaging approximately $3,000 per month.

13. By virtue of the provisions of Articles I, II, V and XIII of Treaty I, finding 10, *supra*, plaintiff at all relevant times had an enforceable right to receive, albeit on an "as earned" basis, its entire share of premiums collected by American Bankers on A & H insurance sold by it to the debtors of Southern and its subsidiaries and affiliates after July 1, 1957. Under the provisions of the Treaty, construed in light of all of the factual circumstances on which it operated, the possibility that plaintiff would not receive its full share of all A & H premiums collected by American Bankers on coverages subject to the Treaty was so remote as to be negligible.

14. By virtue of the provisions of Articles I and XIII plaintiff assumed and completely retained the entire insurance risk of all A & H coverages sold by American Bankers after July 1, 1957 to Southern's debtors and those of its subsidiaries and affiliates.

15. For each of the years in suit plaintiff prepared and filed annual reports with the proper authorities in Arizona and Georgia, as required by the laws of those states. On those reports covering the years in which Treaty I was in force plaintiff re-

ported premium income from life insurance in the full amount of its 87½ percent share of premiums collected during the year by American Bankers. Correspondingly, it reported as a liability the full tabular reserve attributable to those life premiums. On A & H insurance, however, plaintiff reported as premium income only those amounts received from American Bankers representing an amortized portion of total premiums attributed to exposure deemed to have expired on a month-to-month basis. It reported no asset or other item representing the portion of A & H premiums on existing policies that it was contractually entitled to receive from American Bankers in the future. Those premiums and a correlative reserve therefor were carried by American Bankers on its own reports and had no effect on its status as a life insurance company for federal tax purposes. Thus, plaintiff reported no unearned premium reserve in respect to the A & H coverages that it reinsured and it reflected no other reserve liability relative to the A & H premiums that it was to receive in the future from American Bankers in accordance with the provisions of Treaty I.

16. The Georgia authorities never challenged plaintiff's reporting treatment of its Treaty I activities. The Arizona authorities examined plaintiff's report for 1961 and required no change in respect to Treaty I items.

17. By 1962 plaintiff had accumulated a sufficient surplus from profits realized under Treaty I to enable it to qualify under the laws of Georgia and

North Carolina to write insurance directly under the laws of those states. Accordingly, on April 18, 1962 plaintiff entered into a new insurance agreement, effective March 1, 1962, with American Bankers. That agreement, referred to herein as Treaty II, provided:

Article I

BASIS OF REINSURANCE

1. On and after the effective date hereof, the Ceding Company's liability under Credit Accident and Sickness policies issued directly by the Ceding Company on the policy forms specified in Schedule A, attached hereto, shall be reinsured automatically to the degree and in the manner hereinafter specified.

2. The reinsurance liability of American Bankers during 1962 shall be 80% of each policy issued by the Ceding Company; thereafter, with respect to new business, such reinsurance liability may be reduced at the option of the ceding company at the beginning of each subsequent calendar year.

3. Reinsurance hereunder shall apply and be subject to all benefits and limitations included in policies issued by the Ceding Company and subject to reinsurance hereunder.

Article II

MODE OF CESSION

1. Reinsurance of Credit Accident and Sickness insurance issued or renewed by the Ceding

Company on and after the effective date of this Agreement shall be effected by the Ceding Company's mailing to American Bankers a reinsurance cession on a form of which a sample is attached hereto and marked Schedule B, not later than the twentieth day following the last day of the calendar quarter covered by the reinsurance cession. The liability of American Bankers shall:

(a) commence as of the effective dates of the reinsurance premiums, and

(b) continue only for the period covered by the reinsurance premiums.

2. In no event shall the reinsurance be in force and binding unless the policy issued by the Ceding Company to the insured is in force.

Article III

REINSURANCE PREMIUMS

1. The reinsurance premiums to be paid the American Bankers by the Ceding Company shall be the premiums charged the insured by the Ceding Company during the calendar quarter for the coverage reinsured.

2. The American Bankers will pay to the Ceding Company a commission of 50% of reinsurance premiums received, as specified in this Article, on reinsurance hereunder.

Article IV

OVERSIGHTS

1. American Bankers shall be bound as the Ceding Company is bound, and it is expressly understood and agreed that if non-payment of premiums within the time specified or failure to comply with the terms of this Agreement is shown to be unintentional and the result of misunderstanding or oversight on the part of either the Ceding Company or American Bankers, both the Ceding Company and American Bankers shall be restored to the positions they would have occupied had no such error or oversight occurred.

Article V

PAYMENT OF CLAIMS

1. At the end of each calendar quarter American Bankers shall reimburse the Ceding Company for American Bankers share of all claim payments made by the Ceding Company during the calendar quarter on policies reinsured hereunder.

2. It is hereby understood and agreed that the American Bankers shall be liable only for claims incurred on or after the effective date hereof.

Article VI

EXPERIENCE REFUNDS

1. Reinsurance ceded hereunder shall be eligible for an Experience Refund. The Experience

Refund for a given calendar quarter shall be computed as follows:

Experience Refund = (P-Co-E-Cl)

where P = earned reinsurance premiums during the calendar quarter as determined by American Bankers.

Co = earned reinsurance commissions during the calendar quarter as determined by American Bankers.

E = an expense, profit, and contingency charge equal to .03P.

Cl = incurred reinsurance claims during the calendar quarter as determined by American Bankers.

2. If P-Co-E-Cl is negative for a given calendar quarter such negative amount will be treated as an addition to the incurred claims in calculating the Experience Refund for the following calendar quarters.

Article VII

TAXES, ASSESSMENTS AND EXPENSES

Neither party hereto shall be liable to the other for taxes, assessments, or any expenses resulting from reinsurance hereunder. The Ceding Company shall furnish the American Bankers with all necessary information so that American Bankers will not be required to perform any office work other than the regular book-

keeping entries made in connection with reinsurance accounting.

Article VIII

INSPECTION OF RECORDS

American Bankers shall have the right at any reasonable time to inspect at the office of the Ceding Company all books and documents relating to the reinsurance under this Agreement.

Article IX

INSOLVENCY

1. In the event of insolvency of the Ceding Company, all reinsurance in force shall be payable to its liquidator or receiver without diminution because of the insolvency of the Ceding Company by any court of competent jurisdiction or any justice or judge thereof, or by any receiver or liquidator having authority to determine and allow such claims. It is understood, however, that in the event of the insolvency of the Ceding Company, the liquidator, receiver or statutory successor of the Ceding Company shall give written notice of the pendency of a claim against the Ceding Company on the policy reinsured with[in] a reasonable time after such claim is filed in the insolvency procedings and that during the pendency of such claim the American Bankers may investigate such claim and interpose, at its own expense, in the proceeding where such claim is to be adjudicated any defense or defenses which it may deem avail-

able to the Ceding Company or its liquidators or receivers or statutory successor.

2. The expense thus incurred by American Bankers shall be chargeable against the Ceding Company as part of the expense of liquidation to the extent of a proportionate share of the benefit which may accrue to the Ceding Company solely as a result of the defense undertaken by American Bankers.

Article X

SETTLEMENT OF CLAIMS

1. American Bankers shall be liable to the Ceding Company for the benefits covered by reinsurance hereunder to the same extent as the Ceding Company is liable to the insured for such benefits and all reinsurance shall be subject to the terms and conditions of the particular form of policy under which the Ceding Company shall be liable.

2. It is hereby understood and agreed that the American Bankers shall be liable only for claims incurred on or after the effective date hereof.

3. Whenever a claim is made under a policy of the Ceding Company, which has been reinsured hereunder, it shall be taken and considered by American Bankers to be a claim for the amount of reinsurance on such risk and American Bankers shall abide the issue as it shall be settled by the Ceding Company and shall pay the amount of reinsurance covered by the policy of reinsurance when the Ceding Company shall settle with the Claimant.

4. Any suit or claim may be contested or compromised on the part of the Ceding Company and in case of a reduction of the claim made upon the Ceding Company, American Bankers and the Ceding Company shall participate in such reduction in the ratio that each company's net liability bore to the total net liability prior to the reduction of the claim. Any unusual expenses incurred by the Ceding Company in defending or investigating any claim or taking up or rescinding any policy reinsured hereunder aside from routine investigations and other expenses incidental to the settlement of claims shall be shared in the same proportion.

5. In every case of loss, copies of proofs obtained by the Ceding Company shall likewise be taken as sufficient by American Bankers and copies thereof, together with a statement showing the amount paid on such claim by the Ceding Company shall be furnished to American Bankers before payment shall be demanded of it.

Article XI

ARBITRATION

1. All disputes and differences between the two contracting parties upon which an amicable understanding cannot be reached are to be decided by arbitration and the arbitrators, who shall regard this treaty from the standpoint of practical business and equity rather than from that of the strict law, are empowered to determine as to the interpretation of the treaty obligation.

2. The court of arbitrators which is to be held in the City of Miami, Florida, shall consist of three arbitrators who must be officers of life insurance companies other than the two parties of this Agreement. One of the arbitrators is to be appointed by the Ceding Company, the second by American Bankers and the third is to be selected by those two representatives before the beginning of the arbitration. Should one of the parties decline to appoint an arbitrator or should the two arbitrators be unable to agree upon the choice of a third, the appointment shall be left to the counsel for the Consumer Credit Insurors Association.

3. The arbitrators are not bound by any rules of law. They shall decide by a majority of votes and from their written decision there can be no appeal. The cost of arbitration, including the fees of the arbitrators, shall be borne by the losing party unless the arbitrators shall decide otherwise.

Article XII

PARTIES TO AGREEMENT

This is an agreement solely between the Ceding Company and American Bankers. The acceptance of reinsurance hereunder shall not create any right or legal relation whatever between American Bankers and the insured or the beneficiary under any policy of the Ceding Company which may be reinsured hereunder.

Article XIII

DURATION

1. This agreement shall be effective as of the 1st day of March 1962, and may be terminated as of the end of any calendar quarter by either party giving to the other not less than 30 days' written notice.

2. Upon termination, as provided in this Article, the Ceding Company shall, within 30 days of the termination date, supply American Bankers with the information necessary to calculate the final experience refund as of the termination date. Payment of (a) the final experience refund,

(b) the unearned premium reserve held by American Bankers less unearned commissions thereon, and

(c) payment of the claim reserve held by American Bankers.

18. On December 2, 1964, effective October 1, 1964, plaintiff and American Bankers executed the following amendment to Treaty II:

ADDENDUM TO REINSURANCE AGREEMENT

THIS AGREEMENT, made this 2nd day of December, 1964, and effective the 1st day of October, 1964, by and between CONSUMER LIFE INSURANCE COMPANY OF PHOENIX, ARIZONA, hereinafter designated as "Ceding Company" and AMERICAN BANKERS LIFE AS-

SURANCE COMPANY OF FLORIDA, a corporation duly organized and existing under and by virtue of the laws of the State of Florida and having its executive office in the City of Miami, and State of Florida, hereinafter designated as "Company".

WITNESSETH:

WHEREAS, the Company and the Ceding Company entered into a Reinsurance Agreement on the 1st day of March, 1962; and

WHEREAS, the parties are mutually desirous of amending said Agreement as hereinafter set forth.

NOW, THEREFORE, IT IS MUTUALLY UNDERSTOOD AND AGREED AS FOLLOWS:

1. The terms and conditions of said Reinsurance Agreement are incorporated within the terms of this Agreement.

2. Article I, Paragraph (2) is hereby amended to read:

> The reinsurance liability of American Bankers shall be 65% of each policy issued by the Ceding Company; thereafter, with respect to new business, such reinsurance liability may be reduced at the option of the Ceding Company at the beginning of each subsequent calendar year.

3. All other conditions are to remain the same.

19. On December 29, 1964, effective December 31, 1964, plaintiff and American Bankers executed the following further amendment to Treaty II:

> AMENDMENT TO Reinsurance Agreement between Consumer Life Insurance Company of Phoenix, Arizona, and American Bankers Life Assurance Company of Florida, of Miami, Florida, dated April 18, 1962. Article VI of above mentioned Reinsurance Agreement is hereby amended to read as follows:
>
> Article VI
>
> EXPERIENCE REFUNDS
>
> 1. Reinsurance ceded hereunder shall be eligible for an Experience Refund. The Experience Refund for a given calendar quarter shall be computed as follows:
>
> Experience Refund = (P-Co-E-Cl-N)
>
> where P = earned reinsurance premiums during the calendar quarter as determined by American Bankers.
>
> Co = earned reinsurance commissions during the calendar quarter as determined by American Bankers.
>
> E = an expense, profit, and contingency charges equal to .03P.
>
> Cl = incurred reinsurance claims during the calendar quarter as determined by American Bankers.

> N = negative carry-forward from prior quarter.
>
> 2. If a negative amount is obtained from the calculation of the Experience Refund for a given calendar quarter, such negative amount will be carried forward in calculating the Experience Refund for the following calendar quarter, provided, however, that any unamortized balance of such negative carry-forward will be dropped from the refund calculation after 20 quarters. The "first-in, first-out" principle will apply to the unamortization of two or more negative carry-forwards arising from the experience of different calendar quarters.
>
> IN WITNESS WHEREOF the parties hereto have caused this Amendment to be executed in duplicate this 29th day of December, 1964, and to be effective for calculating the Experience Refund due for the calendar quarter ending December 31, 1964.

20. By virtue of the provisions of Articles I, II, VI and XIII, and particularly those of Article VI dealing with Experience Refunds, plaintiff assumed the entire insurance risk under all of the A & H policies covered by Treaty II. Because of Article VI, American Bankers' pecuniary interest in Treaty II, aside from investment return on premiums temporarily held, was fixed at 3 percent of the A & H premiums covered by the Treaty, without regard to loss experience. Only if loss experience under the subject coverages exceeded 97 percent of premium income could American Bankers' receipt of its 3

percent participation be delayed to a subsequent quarterly period. The likelihood that loss experience on the A & H coverages subject to Treaty II would run as high as 97 percent was so remote as to be negligible and the parties knew this. They had accumulated extensive prior loss experience, both under Treaty I and prior thereto, with such coverage. That experience reflected losses ranging from 28 to 30 percent of premiums earned. On December 29, 1964 when the parties excuted the amendment of Article VI of Treaty II, as set forth in finding 19, *supra*, loss experience on A & H coverages subject thereto was running at the rate of 18 percent.

21. On its annual reports covering the A & H transactions subject to Treaty II plaintiff did not reflect any unearned premium reserves; this on the premise that by virtue of Treaty II, American Bankers was the reinsurer of the A & H coverages subject thereto and that, to the extent of such reinsurance, plaintiff was entitled to take a credit against (*i.e.*, to reduce) the reserves that it would otherwise be required to maintain as the originating carrier of such coverages. American Bankers conformed with this approach in preparing its own reports but its recognition of the reserves in question had no disqualifying effect on its status as a life insurance company for federal tax purposes.

22. The essence of insurance is risk-shifting and risk-distribution.

23. Reinsurance is insurance by the first insurer of the whole or some part of his interest in the risk created by his original contract of insurance.

24. Under Treaty I plaintiff reinsured the entire insurance risk created by American Bankers under the A & H coverages subject thereto. Under Treaty II American Bankers did not function as a reinsurer. Its function was rather that of a supplier of essentially clerical services for a fixed fee with plaintiff assuming and retaining the entire insurance risk under the coverages subject thereto.

25. In the opinion of Mr. Arthur Crooks Eddy, an actuary who testified as an expert for the plaintiff in this proceeding and for the plaintiff in *Penn Security Life Insurance Co.* v. *United States*, Ct. Cl. No. 109-68 (Tr. Judge Op. March 2, 1973), and *Economy Finance Corp.* v. *United States*, 501 F.2d 466 (7th Cir. 1974), an insurer having an enforceable contractual right to receive premiums in the future respecting existing coverage on which it bears some or all of the insurance risk is obliged by prevailing state law and practice to reflect the amount of those premiums receivable as an asset on its annual reports and to concurrently reflect a concomitant liability, in the nature of an unearned premium reserve in the case of A & H coverage—a reserve relating to the underlying exposure assumed in consideration of the right to receive such premiums in the future.

26. The Georgia Code Annotated contains the following provisions, by section, applicable to the insurance activities in suit:

56-901. "*Assets*" *defined.*—In any determination of the financial condition of an insurer, there shall be allowed as assets only such assets as are owned by the insurer and which consist of:

* * * *

(6) Premiums in the course of collection, other than for life insurance and annuity considerations, not more than three months past due, less commissions payable thereon. The foregoing limitation shall not apply to premiums payable directly or indirectly to the United States Government or by any state of the Union or by any of their instrumentalities;

(7) Installment premiums other than life insurance premiums to the extent of the unearned premium reserves carried thereon;

(8) Notes and like written obligations not past due, taken for premiums other than life insurance premiums, on policies permitted to be issued on such basis, to the extent of the unearned premium reserves carried thereon;

(9) The full amount of reinsurance recoverable by a ceding insurer from a solvent reinsurer and which reinsurance is authorized under section 56-413;

(10) Amounts receivable by an assuming insurer representing funds withheld by a solvent ceding insurer under a reinsurance treaty;

* * * *

56-905. *Liabilities.*—In any determination of the financial condition of an insurer, capital stock and liabilities to be charged against its assets shall include:

* * * *

(3) With reference to life and disability insurance and annuity contracts:

(a) The amount of reserves on life insurance policies and annuity contracts in force, valued according to the tables of mortality, rates of interest, and methods adopted pursuant to this Title which are applicable thereto,

(b) Reserves for disability benefits, for both active and disabled lives,

(c) Reserves for accidental death benefits, and

(d) Any additional reserves which may be required by the Commissioner consistent with practice formulated or approved by him, on account of such insurance;

* * * *

56-906. *Unearned premium reserve.*—(1) With reference to insurance against loss or damage to property (except as provided in section 56-907) and with reference to all general casualty insurance and surety insurance, every insurer shall maintain an unearned premium reserve on all policies in force.

(2) The Commissioner may require that such reserves shall be equal to the unearned portions of the gross premiums in force after deducting reinsurance in solvent insurers as computed on each respective risk from the policy's date of issue. If the Commissioner does not so require, the portions of the gross premium in force, less reinsurance in solvent insurers to be held as a premium reserve, shall be computed according to the following table:

Term for Which Policy Was Written	Reserved for Unearned Premium
1 year or less	1/2
2 years	1st year 3/4 2nd year 1/4
3 years	1st year 5/6 2nd year 1/2 3rd year 1/6
4 years	1st year 7/8 2nd year 5/8 3rd year 3/8 4th year 1/8
5 years	1st year 9/10 2nd year 7/10 3rd year 1/2 4th year 3/10 5th year 1/10
Over 5 years	pro rata.

(3) Unearned premium reserves on policies written for an intermediate period shall be calculated on a monthly pro rata basis.

(4) In lieu of computation according to the foregoing table, all of such reserves may be computed, at the option of the insurer, on a monthly or more frequent pro rata basis.

(5) After adopting a method of computing such reserve, a domestic insurer shall not change methods without approval of the Commissioner and a foreign or alien insurer shall not change methods without approval of the insurance supervisory official of the state of its domicile.

(6) This section does not apply to title insurance.

* * * *

56-908. *Reserves for accident and sickness insurance.*—For all accident and sickness policies the insurer shall maintain an active life reserve which shall place a sound value on its liabilities under such policies and which shall not be less in the aggregate than the reserve according to the standards set forth in regulations issued by the Commissioner and, in no event, less than the pro rata gross unearned premium reserve for such policies.

27. The following sections of the Arizona Revised Statutes are germane to the insurance activities in suit:

§ 20-223. *Annual statement*

A. Each authorized insurer shall annually on or before March 31 file with the director a true statement of its financial condition, transactions and affairs as of the December 31 preceding. The statement shall be in such general form and context as approved by the national association of insurance commissioners for the kinds of insurance to be reported upon, and as supplemented for additional information required by the director.

* * * *

§ 20-501. *"Assets" defined*

In any determination of the financial condition of an insurer, there shall be allowed as assets only such assets as are owned by the insurer and which consist of:

* * * *

5. Premiums in the course of collection, other than for life insurance, not more than three months past due, less commissions payable thereon. The foregoing limitation shall not apply to premiums payable directly or indirectly by the United States or by any of its instrumentalities.

6. Installment premiums other than life insurance premiums, in accordance with regulations prescribed by the director consistent with practice formulated or adopted by the national association of insurance commissioners.

7. Notes and like written obligations not past due, taken for premiums other than life insurance premiums, on policies permitted to be issued on such basis, to the extent of the unearned premium reserves carried thereon.

8. The full amount of reinsurance recoverable by a ceding insurer from a solvent reinsurer and which reinsurance is authorized under § 20-261.

9. Amounts receivable by an assuming insurer representing funds withheld by a solvent ceding insurer under a reinsurance treaty.

* * * *

§ 20-505. *Liabilities*

In any determination of the financial condition of an insurer, capital stock and liabilities to be charged against its assets shall include:

* * * *

3. With reference to life and disability insurance and annuity contracts:

(a) The amount of reserves on life insurance policies and annuity contracts in force, valued according to the tables of mortality, rates of in-

terest, and methods adopted pursuant to this title which are applicable thereto.

(b) Reserves for disability benefits, for both active and disabled lives,

(c) Reserves for accidental death benefits.

(d) Any additional reserves which may be required by the director consistent with practice formulated or approved by the national association of insurance commissioners, on account of such insurance.

* * * *

§ 20-506. *Unearned premium reserve*

A. With reference to insurance against loss or damage to property, except as provided in § 20-507, and with reference to all general casualty insurance, disability insurance, except as provided in §§ 20-508 and 20-510, and surety insurance, every insurer shall maintain an unearned premium reserve on all policies in force.

B. The director may require that such reserve be equal to the unearned portions of the gross premiums in force after deducting reinsurance in solvent insurers as computed on each respective risk from the policy's date of issue. If the director does not so require, the portions of the gross premiums in force, less reinsurance in solvent insurers to be held as a premium reserve, shall be computed according to the following table:

Term for Which Policy Was Written	Reserve for Unearned Premium
1 year or less	1/2
2 years	1st year 3/4 2nd year 1/4
3 years	1st year 5/6 2nd year 1/2 3rd year 1/6
4 years	1st year 7/8 2nd year 5/8 3rd year 3/8 4th year 1/8
5 years	1st year 9/10 2nd year 7/10 3rd year 1/2 4th year 3/10 5th year 1/10
Over 5 years	Pro rata

28. On the basis of the proofs and representations of the parties the following numbered findings of fact were made by the Trial Judge in *Penn Security Life Insurance Co.* v. *United States*, Ct. Cl. No. 109-68:

> 1. Plaintiff was incorporated on August 8, 1955, under the statutes of the State of Missouri applicable to the organization of life insurance companies. It is empowered by its Articles of Incorporation and authorized by the insurance authorities of the State of Missouri to engage in the business of issuing contracts insuring or reinsuring against death or disability, and has carried on such business exclusively.
>
> * * * *

> 4. Plaintiff's principal business, until approximately 1966, consisted of reinsuring death and disability risks underwritten by unrelated insurance companies in respect to credit life insurance policies issued by those companies to Aetna and its loan customers. By 1967, plaintiff's volume of business increased to the point at which it became more profitable for it to write its own credit insurance policies than to reinsure other companies. Plaintiff today writes a complete portfolio of the standard forms of ordinary and term insurance contracts including individual and group life, accident and health, and surgical coverages, as well as credit insurance for borrowers and installment purchasers.
>
> * * * *
>
> 15. The determination of the Commissioner of Internal Revenue that plaintiff was not a "life insurance company" as defined in Section 801 of the Code in 1963, 1964, and 1965 was based upon his inclusion in plaintiff's "total reserves" of unearned gross premiums actually held by the ceding companies (*i.e.*, Old Republic, Pilot, and National Fidelity) in respect of disability benefits under credit life insurance policies (combined with health and accident insurance) issued by those companies to Aetna and its loan customers. The amounts of "unearned premiums" added by the Commissioner of Internal Revenue to plaintiff's "total reserves" as of December 31, 1962, 1963, 1964, and 1965 were as follows:

From	Unearned Premiums Attributed to Plaintiff 12-31-62	12-31-63	12-31-64	12-31-65
Old Republic	$ 183,342	$ 147,375	$ 145,833	$ 191,416
Pilot	728,821	782,726	724,445	829,480
National Fidelity	413,973	495,288	570,083	773,670
	1,326,635	1,425,389	1,440,351	1,794,566

The Government now concedes that unearned premiums under the Old Republic Disability Reinsurance Treaty are not attributable to taxpayer for purposes of qualification as a life insurance company.

16. The unearned premiums attributed to plaintiff by the Commissioner of Internal Revenue as of December 31, 1962, 1963, 1964, and 1965 were actually held by the ceding companies on those dates and were included in the unearned premium reserves shown on the annual statements which they submitted to the insurance authorities of the various states in which they did business. In recognition of their continuing obligations to their policyholders, the ceding companies were required, both from an actuarial standpoint and under state law, to establish such unearned premium reserves while they actually held the unearned premiums in order to have funds available to pay claims and refunds to their policyholders and to reflect the fact that they had received premiums from policyholders for insurance protection to be provided after the statement date. The annual statements of those

companies, in which the unearned premiums which the Commissioner of Internal Revenue now seeks to include in plaintiff's reserves were shown as unearned premiums of the ceding companies, were accepted by the insurance authorities in all the states in which the ceding companies did business.

* * * *

18. Plaintiff had separate reinsurance treaties covering life insurance risks and disability insurance risks with each of the ceding companies during the years in issue. Under the disability reinsurance treaties, plaintiff agreed to reinsure 100 percent of the liability of each ceding company with respect to disability benefits included in credit life insurance policies issued to Aetna and its loan customers. The treaties provided for payment of a monthly reinsurance premium equal to 98 percent (89 percent under the Old Republic treaty) of the premiums earned with respect to credit accident and health insurance in force during the previous month. The following excerpts from the Pilot treaty are typical:

Article I.

* * * Pilot Life agrees to reinsure with [Taxpayer] one hundred per cent (100%) of the total of all Credit Accident and Health issued by Pilot Life covering the debtors of Aetna Finance Company. * * *, and [Taxpayer] agrees to accept such reinsurance automatically.

Article II.

1. The liability of [Taxpayer] on all reinsurances shall begin simultaneously with that of

Pilot Life and in no event shall the reinsurance of [Taxpayer] be in force and binding unless the policy issued by Pilot Life is in force.

2. In all reinsurances the liability of [Taxpayer] shall cease when the liability of Pilot Life ceases.

* * * *

Article III.

1. Reinsurance payments to [Taxpayer] shall be made on or before the twenty-fifth of each calendar month, on a monthly term basis, based on all accident and health insurance in force during the previous month on policies reinsured with [Taxpayer].

2. The premium payable in any month shall be ninety-eight per cent (98%) of the earned premiums the previous month for all accident and health policies reinsured hereunder. Earned premiums for any month on such policies are all premiums written during such month, less returned premiums on such policies during such month, plus unearned premium reserves on such policies at the beginning of the month, and less the unearned premium reserves on such policies at the end of such month.

3. From the reinsurance premium due [Taxpayer] shall be deducted and withheld by Pilot Life:

A. The following expenses which are assumed by [Taxpayer]:

(1) All premium, occupational and privilege taxes applicable to the insurance.

(2) The cost of policy forms.

(3) Any special claim expense incurred by Pilot Life in accordance with Section 3 of Article IV hereof, and

(4) Any commissions paid to or retained by agents for writing the insurance; and

B. The total of all claims paid under reinsured policies during the period for which the premium is due.

4. If, at the time established for making any premium remittance, the total of the deductions listed in the preceding Section of this Article exceeds ninety-eight per cent (98%) of the earned premium for the period covered, [Taxpayer] shall pay to Pilot Life the amount of such excess upon receipt of a statement of the amount of such excess.

5. If this agreement is terminated as to new insurance, Pilot Life shall nevertheless be liable to [Taxpayer] for payment of monthly reinsurance premiums until all premiums on policies reinsured with [Taxpayer] prior to the termination have been earned, and [Taxpayer] shall nevertheless be liable to Pilot Life for payment of all claims arising out of policies reinsured with [Taxpayer] prior to the termination. After all reinsurance premiums have been paid, [Taxpayer] shall pay Pilot Life the amount of any claims on such reinsured policies, which claims were paid by Pilot Life and not deducted from reinsurance premiums, upon receipt of a statement of the amount of any such claims.

* * * *

19. Plaintiff's disability reinsurance treaties with the ceding companies fell into the category

of "reinsurance ceded"; *i.e.*, they were solely contracts of insurance between two insurance companies (the "ceding company" and the "reinsurer"), and did not create any contractual obligation running from the reinsurer (plaintiff) to the policyholders of the ceding companies. Such reinsurance did not relieve the ceding companies of contractual liabilities to their policyholders, *e.g.*, the obligation to pay benefits and to refund unearned premiums in the event of cancellation or other termination of a policy before the expiration of its full term. Consequently, the mere fact that the ceding companies obtained reinsurance from plaintiff under these treaties did not affect their responsibility, under state law or under actuarial principles, to set up an unearned premium reserve to reflect the unearned premiums actually held by those companies or policies covered by reinsurance treaties with plaintiff. Ceding companies, however, may obtain a credit on their annual statement forms for unearned premium reserves actually transferred to a reinsurer since, as explained by plaintiff's expert, the liability for an unearned premium reserve "depends on whether you've got the money or not . . ."

29. By virtue of Articles I and III, subparagraph 5, of the Treaty set forth under paragraph 18 of the preceding finding the plaintiff in *Penn Security* assumed the entire insurance risk under the coverages subject thereto and had an enforceable contractual right to receive, over the respective lives of the individual coverages involved, substantially the entire premiums collected thereon from

the insureds by the ceding carriers. According to the testimony of Arthur Crooks Eddy in the present proceeding, a right to receive premiums in the future, such as Penn Security had under the treaties to which it was a party, must be reported to the state regulatory authorities as an asset and must be accompanied by a liability item in correlative amount, in the nature of an unearned premium reserve against the asset receivable.

30. During the period in suit in *Penn Security*, VERNON'S ANNOTATED MISSOURI STATUTES included the following provision:

> 376.410. *Insurance companies to maintain reserves—exemptions*
>
> Except as provided in subdivision (6) of this section, all companies organized under the laws of this state, and engaged in writing policies of accident or health insurance, or combination policies of accident and health insurance, and all other companies transacting such kinds of business in this state, shall maintain reserves thereon in accordance with the following requirements:
>
> (1) On all such policies actually written there shall be maintained an unearned gross premium reserve which reserve may be computed on a *pro rata* basis or such reserve may be computed at not less than fifty per cent of the gross premiums in force
>
> (2) On all such policies written on a noncancellable plan and under the terms of which

the company is obligated to renew or continue for a stated period, or to a stated age or for life, there shall be maintained active life reserves and reserves for losses in amounts not less than such minimum standards which the superintendent of insurance shall determine and prescribe after giving proper consideration to the terms and conditions of the policies involved;

(3) On all such policies other than those written on a noncancellable plan there shall be maintained reserves for losses in amounts not less than the minimum standards which the superintendent of insurance shall determine and prescribe after giving proper consideration to the terms and conditions of the policies involved;

(4) In the calculation of reserves required to be maintained under this section, proper credit shall be allowed for reinsurance in other companies licensed to do business in this state;

(5) In addition to the minimum reserves mentioned above the superintendent of insurance may also require such companies to maintain reserves for extraordinary losses in amounts not less than such minimum standards which the superintendent of insurance shall determine and prescribe after giving proper consideration to the terms and conditions of the policies involved;

(6) This section shall not be applicable to total and permanent disability benefits, or to accidental death benefits, contained in or supplementary to life insurance policies or other contracts and for which benefits the standard of valuation is prescribed by section 376.380.

31. In its federal income tax returns for the years in issue, plaintiff treated the reinsurance treaties (Treaties I and II) as it had in its annual statements. It reported the reserves on the life insurance policies on which it was reinsurer under Treaty I and on the life policies which it wrote directly during the subsequent period when Treaty II was in force but it did not report any unearned premium reserves on the accident and health policies covered by either treaty. By not taking those reserves into account, plaintiff's life insurance reserves were shown on its returns as totaling more than 50 percent of its total reserves. It therefore claimed qualification as a life insurance company under Section 801 of the Internal Revenue Code of 1954.

32. Following an audit the Internal Revenue Service issued notices of deficiency for the years in issue disallowing plaintiff's taxable status as a life insurance company. It did so on the premise that the unearned premiums on the accident and health insurance covered by Treaties I and II should have been included in taxpayer's total reserves. Had they been so included, plaintiff's life insurance reserves would have constituted less than 50 percent of its total reserves and it would not therefore have qualified as a life insurance company. Deficiencies were duly assessed accordingly. Following payment and the rejection of refund claims filed by plaintiff, this suit was seasonably brought.

CONCLUSION OF LAW

Upon the foregoing findings of fact, which are adopted by the court and made a part of the judgment herein, the court concludes as a matter of law that the plaintiff is not entitled to recover and its petition is dismissed.

APPENDIX B

IN THE UNITED STATES COURT OF CLAIMS

No. 463-70

(Decided October 22, 1975)

CONSUMER LIFE INSURANCE COMPANY

v.

THE UNITED STATES

E. Michael Masinter, attorney of record, for plaintiff. *James H. Landon* and *Hansell, Post, Brandon & Dorsey*, of counsel.

Herbert Grossman, with whom was *Assistant Attorney General Scott P. Crampton*, for defendant. *Theodore D. Peyser*, of counsel.

Before COWEN, *Chief Judge*, LARAMORE, *Senior Judge*, SKELTON, NICHOLS, KASHIWA, KUNZIG, and BENNET, *Judges*.

OPINION

KASHIWA, *Judge*, delivered the opinion of the court:

This is a single issue tax refund suit that arises out of a small loan company's entry into the insurance business through a wholly owned subsidiary that is formed especially for that purpose. The question is whether that subsidiary, the plaintiff in this proceeding, qualified for the tax treatment accorded a "life insurance company" by §§ 801 et seq. of the Internal Revenue Code of 1954. We hold for the plaintiff.

This case is before this court on a review of a recommended decision of Trial Judge George Willi. The court disagrees with the conclusions. A similar case, *Penn Security Life Insurance Co.* v. *United States* (Ct. Cl. No. 109-68), is decided contemporaneously herewith. Issues decided therein and applicable herein are disposed of by reference to said decision; but as hereafter shown, plaintiff in this case has raised new questions based on state regulatory statutes. This decision discusses these state statutes which defendant claims are relevant.

The facts are fully detailed in the findings of fact accompanying this opinion and will be repeated herein only to the extent necessary to an understanding of the result reached.

In 1957 Southern Discount Company (Southern), a Georgia corporation, was operating a well established and successful consumer finance business. Its customer-borrowers typically purchased term life and accident and health (A & H) insurance at the time that they obtained their loans. The premium charge for the entire coverage involved was thereupon paid

in full. The customers bought this protection, coextensive in both time and amount with the curtailment requirements of their borrowings, to provide a means of automatically servicing their debts to Southern in case of death or disability prior to full repayment. Georgia law prohibited Southern, as a loan company, from acting as an insurance underwriter with respect to such coverages. It was not forbidden, however, from functioning as a sales agent for insurance underwritten by a carrier duly qualified to conduct an insurance business in Georgia. American Bankers Life Insurance Company (American Bankers), a Florida corporation, was such a carrier.

Until 1957 Southern acted as a commission sales agent for American Bankers in respect to life and A & H insurance issued by the latter to Southern's borrowers. Under this arrangement, Southern received the maximum commission rate allowed by law; amounting to approximately 50 percent of the policyholder premiums. Despite the attractiveness of that return, for which it apparently had to do little more than place American Bankers' policies with its own borrowers, Southern concluded that it could reap even greater profits from this source if it could participate as an underwriter rather than just a sales agent. It was that determination that prompted Southern to form the plaintiff as a wholly owned subsidiary.

Southern surveyed state law to locate the jurisdiction that had the most modest capitalization requirements for a licensed insurer and found that it was

Arizona. Plaintiff was organized July 1, 1957 as an insurance company under an Arizona charter with an initial balance of invested capital and paid-in surplus of only $38,000. These resources were not sufficient to permit it to qualify as a direct insurer under Georgia law. It could, however, use its Arizona charter authority to operate as a reinsurer of Georgia and North Carolina coverages written by American Bankers—a duly authorized insurer in both of those states. American Bankers was willing to enter into a reinsurance treaty arrangement with plaintiff, under which it surrendered substantially all underwriting profit in return for a relatively minimal fixed fee, because it knew that if it refused, Southern would have no difficulty in replacing it with another qualified carrier. Thus, its alternative was outright exclusion from the insurance business generated by Southern's borrowers. Thereupon, on June 28, 1957, American Bankers entered into the first of two consecutive insurance treaties (Treaty I and Treaty II, respectively) with the plaintiff.

Under Treaty I, all life and A & H policies issued by American Bankers to debtors of plaintiff's affiliates (including the parent, Southern) on and after July 1, 1957 were to be fully reinsured with plaintiff which, as it freely concedes, thereby assumed the entire insurance risk represented by each of the policies involved; A & H as well as life. As compensation for its reinsurance function, plaintiff was to receive 87½ percent (later increased to 90½

percent) of all premiums collected by American Bankers from the policyholders. The timing of these payments by American Bankers to plaintiff differed, however, as between life and A & H, although the agreement required monthly remittances in each instance. As already noted, American Bankers collected all premiums in full at the inception of coverage. The Treaty stipulated that as to life policies, American Bankers was, at the end of each month, to pay plaintiff its entire share of all life premiums collected from policyholders during that month. As to A & H, however, American Bankers was to pay plaintiff only the portion of its total share of premium receipts during that month that was ratably allocable to that month's coverage; the agreement being to pay over the remainder monthly on a pro rata basis spread over the balance of the coverage period. Thus, in respect to A & H, plaintiff never actually held any premium dollars attributable to a future period of coverage and risk exposure.

Finally, Treaty I provided for termination by either party upon thirty days written notice to the other. Termination was to be wholly prospective, the relevant clause specifying: "Upon termination by either party, this agreement shall continue to apply to all policies reinsured hereunder before such termination becomes effective."

As required by state law, plaintiff filed annual reports of its activities under Treaty I with the insurance regulatory authorities in Arizona and Georgia. On those reports it characterized its life and

A & H dealings differently. It did so by reporting both premium income and related reserves solely on the basis of actual dollar receipts for the year involved. This meant that for the life coverages it declared as premium income its entire percentage share of the premiums paid by policyholders during that year. Consonantly, it reported the full tabular reserve for all of such policies. As to A & H, however, it limited reported premium income to the annual aggregate of the incremental payments that had been received monthly from American Bankers. Moreover, it showed nothing on the asset side of the report representing the premiums on existing A & H policies that it was entitled under the Treaty to receive in the future. With premium income and asset balances thus restricted, plaintiff reported no reserves whatever in respect to the A & H coverages that it reinsured under Treaty I. As to those coverages, American Bankers included on its own annual reports an unearned premium reserve based on the amount of A & H premiums collected from policy holders but not yet paid over to the plaintiff. Neither the Georgia nor the Arizona regulatory authorities ever challenged or disapproved the method by which plaintiff reported its A & H reinsurance activities under Treaty I.

By 1962 plaintiff had accumulated enough earnings from operations under Treaty I to enable it to qualify as a direct insurer under Georgia and North Carolina law. It thereupon applied for and received such authority from the State of Georgia. From then

on plaintiff operated as the issuing company on all life and A & H policies sold to the loan customers of Southern and its affiliates. Treaty I, in which plaintiff's role was solely that of a reinsurer, was consequently no longer suited to its purposes. Accordingly, effective March 1, 1962, plaintiff and American Bankers entered into a new insurance treaty under which their roles were reversed; plaintiff functioning as the issuing or ceding carrier and American Bankers denominated the "reinsurer".

Treaty II applied only to A & H insurance; plaintiff having determined to underwrite all future life insurance by itself. The treaty provided that plaintiff, as the issuing or ceding company, would reinsure 80 percent of all future A & H policies with American Bankers. To that extent, plaintiff was to pay over to American Bankers on a quarterly basis all of the premiums collected from policyholders, American Bankers to return 50 percent of such amounts to the plaintiff as commissions. The Treaty contained a clause, entitled Experience Refunds, establishing a quarterly rebate due plaintiff in the amount of the total premium dollars ratably allocable to the expired portion of the term of policies for which such premiums had been collected, less the following deductions: (a) the amount of commissions paid plaintiff that was proportionate to the expired portion of the term of policies on which such commissions had been paid; (b) 3 percent of the earned premium dollars previously described; and (c) the sum of all claim payments made to

plaintiff during the quarter by American Bankers as reinsurer. For all practical purposes, this clause served to fix American Bankers' stake in the undertaking at a flat 3 percent of the premium dollars that it initially received from the plaintiff. Only if loss experience under the reinsured coverages exceeded 47 percent of premiums would American Bankers' 3 percent return be encroached. Moreover, such a pattern of adverse experience would have had to persist for the ensuing twenty consecutive quarters before such an encroachment became permanent. Loss experience on A & H policies under Treaty I had ranged from 28 to 30 percent. Finally, there were no circumstances under which American Bankers' return under Treaty II could exceed the 3 percent allotted to it therein.

On its annual reports to the state regulatory authorities covering 1962 and subsequent years, plaintiff declared no reserves relative to that portion of the A & H policies covered by the reinsurance language of Treaty II. Again, no state regulatory authority took exception to this aspect of plaintiff's reports.

The insurance industry is regulated by the states. A particular insurance company must meet the various industry requirements of its home state, and must satisfy the requirements of all states in which it is qualified to act as an insurer. The state requirements include standards for investments, maintenance of reserves, and accounting practices. The state insurance departments supervise policy forms, agency re-

lationships, and the general financial activities of the companies within their jurisdictions. This regulation is designed to preserve the solvency of the insurance companies for the protection of the policyholders. To implement their regulatory function, state insurance departments require companies to file annual reports. Because reports are required in all states in which a company is qualified to act as an insurer, a standard report form has been developed by the National Association of Insurance Commissioners, which is used in all fifty states. These reports disclose, among other things, the reserves being maintained by each company.

In addition to requiring annual reports, the various state insurance departments conduct regular triennial examinations of insurance companies. Where the volume of business warrants it as to a particular company, it is customary for representatives of several state insurance departments to work together on these examinations. The examinations are carried out at the offices of the company in question and may take as long as several months for large companies. Among the matters which are investigated in the course of such an examination are the reinsurance treaties to which a particular company is a party.

When a state insurance department is presented with a reinsurance agreement in existence between parties, its investigation will include a determination that each party has established adequate reserves according to its respective liabilities pursuant to the terms of the reinsurance agreement.

Plaintiff was the subject of triennial examinations in 1959 and 1963 by the insurance department of Arizona. American Bankers was the subject of triennial examinations in 1960 and 1963. Participants in the 1960 examination were from the insurance departments of Florida, North Carolina, Georgia, and Texas; and participants in the 1963 examination were from the insurance departments of Florida, Georgia, Arizona, and Arkansas. The reinsurance treaties between plaintiff and American Bankers were examined in detail in the course of the aforesaid examinations. The existence of reserves for accident and health insurance held by American Bankers on the policies covered by those treaties was clear to the examiners. Also the maintenance of the reserves by American Bankers under the treaties during Period I and Period II was approved in the course of the four examinations; no requirement or even suggestion was made in the examination reports that the reserves should be otherwise maintained.

For each of the years 1958 through 1964 plaintiff computed its federal income tax liabilities and filed its returns on the premise that it was taxable as a "life insurance company" within the meaning of that term as defined by Section 801 of the Internal Revenue Code of 1954. On audit, the Revenue Service determined that plaintiff did not qualify as a life insurance company entitled to the preferential tax treatment accorded such an entity and assessed deficiencies accordingly (except for 1961 in which additional liability was fully expunged by other adjust-

ments not in dispute). Plaintiff paid the assessments and upon formal disallowance of its seasonably filed claims for refund, brought this action in which the sole question for decision is that concerning plaintiff's qualification as a life insurance company for federal tax purposes in the years 1958, 1959, 1960, 1962, 1963, and 1964.

As pertinent here, Section 801 defines a life insurance company as follows:

> SEC. 801 [as amended by Sec. 2, Life Insurance Company Income Tax Act of 1959, P.L. 86-69, 73 Stat. 112]. DEFINITION OF LIFE INSURANCE COMPANY.
>
> (a) *Life Insurance Company Defined.*—For purposes of this subtitle, the term "life insurance company" means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance), or noncancellable contracts of health and accident insurance, if—
>
> (1) its life insurance reserves (as defined in subsection (b)), plus
>
> (2) unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, health, or accident policies not included in life insurance reserves,
>
> comprise more than 50 percent of its total reserves (as defined in subsection (c)).
>
> * * * * *
>
> (c) *Total Reserves Defined.*—For purposes of subsection (a), the term "total reserves" means—

(1) life insurance reserves,

(2) unearned premiums, and unpaid losses (whether or not ascertained), not included in life insurance reserves, and

(3) all other insurance reserves required by law.

The term "total reserves" does not include deficiency reserves (within the meaning of subsection (b)(4)).

* * * * *

Life insurance company status, it is seen, is made to depend solely on the character and composition of an insurance company's reserves. An insurance company merits life insurance company tax treatment if its life reserves amount to half or more of its total insurance reserves. Section 801(c) expressly directs that total reserves, the denominator portion of the fractional test, shall include three separate categories: (1) life reserves; (2) reserves for unearned premiums and for certain unpaid losses (the latter element not being involved in this suit); and (3) all other reserves required by law.[1]

Sections 1.801-3(e) and 1.801-5(b) of the Treasury Regulations on Income Tax (1962), endorsed by both parties to the present controversy, define unearned premiums and reserves required by law, respectively, as follows:

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[1] The last-mentioned category has been traditionally and centrally implicated in the federal taxation of insurance companies. *See Brown* v. *Helvering*, 291 U.S. 193, 201 (1934), and cases cited therein.

Unearned premiums. The term "unearned premiums" means those amounts which shall cover the cost of carrying the insurance risk for the period for which the premiums have been paid in advance. Such term includes all unearned premiums, whether or not required by law.

* * * * *

Reserves required by law defined. For purposes of part I, subchapter L, chapter 1 of the Code, the term "reserves required by law" means reserves which are required either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute, and which are reported in the annual statement of the company and accepted by state regulatory authorities as held for the fulfillment of the claims of policyholders or beneficiaries.

In this case there is no disagreement as to either the fact or the particular amount of plaintiff's life insurance reserves for each of the years in suit. Its qualification depends entirely on the question of its chargeability with reserves incident to the A & H policies to which it was a party under Treaties I and II; there being no dispute that reserves must be maintained by someone in respect to those policies. If those reserves are includable in plaintiff's total reserves, it concededly does not pass the 50 percent test of Section 801. If, as plaintiff says, they are chargeable to American Bankers rather than to itself, it does.

To dispel the notion that it was required to maintain A & H reserves of a type comprehended by Sec-

tion 801, plaintiff relies on (1) the language of the two insurance treaties under which it operated with American Bankers; (2) the testimony of a well-traveled actuarial expert, Arthur Crooks Eddy; (3) the fact that the state insurance regulatory personnel tacitly approved plaintiff's annual report forms showing no A & H reserves; and (4) Trial Judge Fletcher's opinion in *Penn Security Life Ins. Co.* v. *United States* (Ct. Cl. No. 109-68, decided March 2, 1973).

Plaintiff's argument is simply that plaintiff was chargeable with no A & H unearned premium reserves because under both of the Treaties it received premium dollars only after the period of exposure to which those dollars related had expired. Accordingly, plaintiff says, since all the premiums that it received were, in point of time, already "earned" when it got them, there was no occasion for it to maintain a reserve for "unearned" premiums. Testifying as plaintiff's expert, Mr. Eddy repeatedly opined that this feature of the Treaties, governing custody of prepaid premium dollars, was dispositive of the participants' respective reserve obligations, *i.e.*, that since it was American Bankers that physically held all of the A & H premium dollars allocable to the unexpired portion of the terms of the underlying policies, it was American Bankers, not plaintiff, that was obligated to carry the reserves for those policies. In this regard, his testimony was the same as it apparently had been in *Penn Security*, *supra*. In the latter case, the relevant particulars of the fac-

tual situations involved were virtually identical to those presented by Treaty I.

Defendant's argument is that plaintiff's total reserves in the reserve ratio must include the unearned premium reserves on the accident and health policies because those reserves must be attributed to the company ultimately liable for the insurance risks. Alternatively, if the unearned premium reserves must be required by law to be recognized, they were so required here.

Issued contemporaneously with this opinion is the per curiam decision in *Penn Security Life Insurance Co.* v. *United States* (Ct. Cl. No. 109-68). That case involves life insurance company qualification and the provisions of § 801 dealing with health and accident insurance. The situation is similar to this case with that taxpayer reinsuring risks written by three unrelated insurance companies under credit life and accident and health policies on the lives and health of debtors of taxpayer's parent which made consumer loans through subsidiaries operating finance offices. That opinion disposes of the issue under § 801(c)(2), unearned premiums, with the court concluding against attribution to plaintiff of the unearned premium reserves held by the ceding companies. We, therefore, consider the question settled. However, this leaves for determination here the § 801(c)(3) issue, insurance reserves required by law.

The defendant's major argument in this case is that the reserves were required by law because Arizona Revised Statutes Annotated § 20-501(5) and

(9)[2] apply in that the premiums were assets of the

[2] § 20-501. *"Assets" defined*

"In any determination of the financial condition of an insurer, there shall be allowed as assets only such assets as are owned by the insurer and which consist of:

"1. Cash in the possession of the insurer, or in transit under its control, and including the true balance of any deposit in a solvent bank or trust company

* * * *

"5. Premiums in the course of collection, other than for life insurance, not more than three months past due, less commissions payable thereon. The foregoing limitation shall not apply to premiums payable directly or indirectly by the United States or by any of its instrumentalities.

"6. Installment premiums other than life insurance premiums, in accordance with regulations prescribed by the director consistent with practice formulated or adopted by the national association of insurance commissioners.

"7. Notes and like written obligations not past due, taken for premiums other than life insurance premiums, on policies permitted to be issued on such basis, to the extent of the unearned premium reserves carried thereon.

"8. The full amount of reinsurance recoverable by a ceding insurer from a solvent reinsurer and which reinsurance is authorized under § 20-261.

"9. Amounts receivable by an assuming insurer representing funds withheld by a solvent ceding insurer under a reinsurance treaty.

"10. Deposits or equities recoverable from underwriting associations, syndicates and reinsurance funds, or from any suspended banking institution, to the extent deemed by the director available for the payment of losses and claims and at values to be determined by him.

"11. All assets, whether or not consistent with the provisions of this section, as may be allowed pursuant to the annual statement form approved by the national association of insurance commissioners for the kinds of insurance to be reported upon therein.

"12. Other assets, not inconsistent with the provisions of this section, deemed by the director to be available for the

plaintiff because they were "the course of collection" and they were "withheld by a solvent ceding insurer under a reinsurance treaty." We interpret these sections to mean that they refer to amounts already due and unpaid. The definition of assets under § 20-501 refers to items in the possession of the taxpayer or to which the taxpayer has an enforceable claim. Without including the unearned premium in taxpayer's assets, there can be no unearned premium reserve charged against that item. The Arizona provisions do not apply to plaintiff's circumstances.

Turning to the liability side of the statute, defendant argues that § 20-505[3] requires that plaintiff establish reserves on the accident and health

payment of losses and claims, at values to be determined by him."

[3] § 20-505. *Liabilities*

"In any determination of the financial condition of an insurer, capital stock and liabilities to be charged against its assets shall include:

* * * *

"3. With reference to life and disability insurance and annuity contracts:

* * * *

"(b) Reserves for disability benefits, for both active and disabled lives,

* * * *

"(d) Any additional reserves which may be required by the director consistent with practice formulated or approved by the national association of insurance commissioners, on account of such insurance.

"4. With reference to insurance other than specified in paragraph 3 of this section, and other than title insurance, the amount of reserves equal to the unearned portions of the gross premiums charged on policies in force, computed in accordance with this article."

* * * *

policies. It would appear from reading this statute that liabilities of an insurer "charged against its assets" implies that there were corresponding assets in the first place. Since there were not, this statute is inapplicable. Section 20-506A,[4] referring to disability insurance, provides that "every insurer shall maintain an unearned premium reserve on all policies in force." If there are two or more insurers on the same policy, they are not all meant to keep a reserve. This is how the state administrative practice operates. As long as someone has the reserve, this is sufficient.

Under Treaty II plaintiff resinsured with American Bankers. This was authorized under Code of Georgia Annotated § 56-413.[5] Section 56-906

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[4] § 20-506. *Unearned premium reserve*

"A. With reference to insurance against loss or damage to property, except as provided in § 20-507, and with reference to all general casualty insurance, disability insurance, except as provided in §§ 20-508 and 20-510, and surety insurance, every insurer shall maintain an unearned premium reserve on all policies in force."

[5] § 56-413. *Authorized reinsurance.* — "(1) An insurer shall reinsure its risks, or any part thereof, only in solvent insurers having surplus to policy holders or trusteed funds on deposit in the United States for the benefit of their policyholders not less in amount than the paid-in capital required under this Title of a domestic stock insurer authorized to transact like kinds of insurance.

"(2) An insurer shall so reinsure in such alien insurers only as either (a) are authorized to transact insurance in at least one state of the United States, or (b) have in the United States a duly authorized attorney-in-fact to accept service of legal process against the insurer as to any liability which might arise on account of such reinsurance, or (c)

(2)[6] provides for a deduction of reinsurance from

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may be approved by the Commissioner. In the event reinsurance is placed which is not in compliance with the foregoing provisions, the ceding insurer shall not be allowed credit for such reinsurance either as an asset or deduction from liability, nor may it increase any amounts it is authorized to have at risk because of such reinsurance.

"(3) No credit shall be allowed, as an asset or as a deduction from liability, to any ceding insurer for reinsurance nor increase the amount it is authorized to have at risk unless the reinsurance is in insurers either authorized to do business in this State, or which have been approved by written order of the Department filed in its office and which order has not been subsequently disapproved; Provided, however, that such credit shall be allowed for reinsurance ceded to unauthorized alien assuming insurers, if such insurers have maintained in the United States for not less than 10 years immediately preceding such reinsurance a trust fund of not less than $50,000,000 available for the purpose of protecting policyholders in the United States. Nor shall such credit be allowed unless the reinsurance is payable by the assuming insurer on the basis of the liability of the ceding insurer under the contracts reinsured without diminution because of the insolvency of the ceding insurer.

* * * *

"(5) Notwithstanding the provisions of this Code, full credit shall be allowed a ceding insurer, as an asset or as a deduction from liability, for all reinsurance which may be in effect or which may be hereafter effected under any contract or reinsurance in effect on the 31st day of December 1959, and any continuations or renewals of such contract of reinsurance. Provided, however, that no new insurance risk shall be ceded after two years from the effective date of this Title unless such reinsurance contract meets all the standards set forth in this Title."

[6] § 56-906

"(2) The Commissioner may require that such reserves shall be equal to the unearned portions of the gross premiums in force after deducting reinsurance in solvent insurers as com-

gross premiums before computing the unearned premium reserve. Arizona Revised Statutes Annotated § 20-261 [7] and § 20-506B [8] are similar. Defendant

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puted on each respective risk from the policy's date of issue. If the Commissioner does not so require, the portions of the gross premium in force, less reinsurance in solvent insurers to be held as a premium reserve, shall be computed according to the following table:"

* * * *

[7] § 20-261. *Authorized reinsurance*

"A. An insurer shall reinsure its risks, or any part thereof, only in solvent insurers having surplus to policyholders not less in amount than the paid-in capital required under this title of a domestic stock insurer, other than a limited stock insurer, authorized to transact like kinds of insurance. A domestic limited stock life insurer may accept reinsurance of the risks of other such limited stock insurers and of domestic benefit insurers.

"B. An insurer shall so reinsure in such alien insurers only as either are authorized to transact insurance in at least one state of the United States, or have in the United States a duly authorized attorney-in-fact to accept service of legal process against the insurer as to any liability which might arise on account of such reinsurance.

"C. No credit shall be allowed, as an asset or as a deduction from liability, to any ceding insurer for reinsurance unless the reinsurance is payable by the assuming insurer on the basis of the liability of the ceding insurer under the contracts reinsured without diminution because of the insolvency of the ceding insurer nor unless under the reinsurance contract the liability for such reinsurance is assumed by the assuming insurer or insurers as of the same effective date."

* * * *

[8] § 20-506

"B. The director may require that such reserves be equal to the unearned portions of the gross premiums in force after deducting reinsurance in solvent insurers as computed

argues that Treaty II is a Surplus Aid contract in that since plaintiff did not reinsure its risks despite the formalities, the treaty did not qualify as authorized reinsurance and plaintiff could not take credit for the reserves. In answer to this, it can only be said that plaintiff did reinsure its risk. American Bankers was responsible for the risk and even though it only kept 3 percent of the premiums, in the event that losses had eaten into the 3 percent, this would have been American Bankers' loss, not plaintiffs.

Defendant then argues that even if Treaty II is operative, plaintiff would have to re-establish the reserve as an offsetting liability to the asset required under paragraph 8 of § 20-501 of the Arizona law. That section is directed primarily toward loss reimbursements for losses paid directly by the ceding company. Therefore, there is no asset belonging to plaintiff because plaintiff does not have an enforceable claim of right against American Bankers.

We observe that the Arizona Code relating to insurance companies provided under § 20-152 for the director of insurance to certify the facts of violation of any provision to the attorney general for enjoining the violation. We also observe that the Georgia Code relating to insurance companies provided under

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on each respective risk from the policy's date of issue. If the director does not so require, the portions of the gross premiums in force, less reinsurance in solvent insurers to be held as a premium reserve, shall be computed according to the following table:"

* * * *

§ 56-214 that the Commissioner may institute legal proceedings for the enforcement of any provisions of the act. For the years in question, none of these actions were taken by either of the state offices in charge. With relation to doubtful or ambiguous statutes, it is generally accepted that in the absence of a court decision, the interpretation placed thereon by the regulatory body charged with enforcement thereof is compelling authority. Federal courts have applied this rule to state administrative interpretations or actions under state statutes. We believe that the language of the court in *Salt Lake County* v. *Kennecott Copper Corp.*, 163 F.2d 484, 489 (10th Cir. 1947) *cert. denied*, 333 U.S. 832, adopting a state administrative interpretation of an ambiguous state statute, is pertinent herein:

> * * * Both the Supreme Court of Utah and this court are firmly committed to the familiar principle of law that in the interpretation of a doubtful or ambiguous statute, the long-continued and uniform interpretation of the administrative agency or authority charged with its administration is entitled to great weight and will not be overturned, except for cogent reasons. An administrative interpretation does not avail to overcome a statute which is so plain in its commands that it leaves nothing for construction; but ordinarily in case of doubt or ambiguity, it is entitled to great weight and will not be overthrown, except for cogent reasons. *State Board of Land Commissioners* v. *Ririe*, 56 Utah 213, 190 P. 59; *Utah Hotel Co.* v. *Industrial Commission*, 107 Utah 24, 151 P.2d 467, 153 A.L.R. 1176; *Utah Power & Light Co.* v. *Public Service Commission*, 107 Utah 155, 152 P.2d 542; *E. C. Olsen Co.* v. *State Tax Commission*, Utah, 168 P.2d 324; *Baze* v. *Scott*, 10 Cir., 106 F.2d 365; *United States* v. *Magnolia Petroleum Co.*, 10 Cir., 110 F.2d 212; *Standard Surety & Casualty Co.* v. *State of Oklahoma*, 10 Cir., 145 F.2d 605. * * *

We believe that the Court's language in *Skidmore* v. *Swift & Co.*, 323 U.S. 134, 139-140 (1944), explains the basic reason for the rule and we deem it appropriate in the present case:

> There is no statutory provision as to what, if any, deference courts should pay to the Administrator's conclusions. And, while we have given them notice, we have had no occasion to try to prescribe their influence. The rulings of this Administrator are not reached as a result of hearing adversary proceedings in which he finds facts from evidence and reaches conclusions of law from findings of fact. They are not, of course, conclusive, even in the cases with which they directly deal, much less in those to which they apply only by analogy. They do not constitute an interpretation of the Act or a standard for judging factual situations which binds a district court's processes, as an authoritative pronouncement of a higher court might do. *But the Administrator's policies are made in pursuance of official duty, based upon more specialized experience and broader investigations and infor-*

mation than is likely to come to a judge in a particular case. They do determine the policy which will guide applications for enforcement by injunction on behalf of the Government. Good administration of the Act and good judicial administration alike require that the standards of public enforcement and those for determining private rights shall be at variance only where justified by very good reasons. The fact that the Administrator's policy and standards are not reached by trial in adversary form does not mean that they are not entitled to respect. This Court has long given considerable and in some cases decisive weight to Treasury Decisions and to interpretative regulations of the Treasury and of other bodies that were not of adversary origin. [Emphasis supplied.]

We consider that the rulings, interpretations and opinions of the Administrator under this Act, while not controlling upon the courts by reason of their authority, do constitute a body of experience and informed judgment to which courts and litigants may properly resort for guidance. The weight of such a judgment in a particular case will depend upon the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it power to persuade, if lacking power to control.

See *New York State Department of Social Services* v. *Dublino*, 413 U.S. 405, 420-421 (1973); *NLRB* v. *Boeing Co.*, 412 U.S. 67, 74-75 (1973); *CBS* v. *Democratic National Committee*, 412 U.S. 94, 121

(1973); *Trafficante* v. *Metropolitan Life Insurance Co.*, 409 U.S. 205, 210 (1972); *Udall* v. *Tallman*, 380 U.S. 1, 16-18 (1965); *Travelers Indemnity Co.* v. *Wells*, 316 F.2d 770, 773 (4th Cir. 1963); *Barrington Manor Apartments Corp.* v. *United States*, 198 Ct. Cl. 298, 304, 459 F.2d 499, 502-503 (1972); *Alabama* v. *United States*, 198 Ct. Cl. 683, 692, 461 F.2d 1324, 1329-30, *cert. denied*, 409 U.S. 1023 (1972); *Inter-City Truck Lines, Ltd.* v. *United States*, 187 Ct. Cl. 290, 295, 408 F.2d 686, 688 (1969); *Cornman* v. *United States*, 187 Ct. Cl. 486, 492, 409 F.2d 230, 233, *cert. denied*, 396 U.S. 960 (1969); *DeLano* v. *United States*, 183 Ct. Cl. 379, 388, 393 F.2d 517, 521 (1968); *Ganse* v. *United States*, 180 Ct. Cl. 183, 189, 376 F.2d 900, 904 (1967); *Citizen Band of Potawatomi Indians* v. *United States*, 179 Ct. Cl. 473, 486-487, 391 F.2d 614, 621 (1967), *cert. denied*, 389 U.S. 1046, 390 U.S. 957 (1968); *Crawford* v. *United States*, 179 Ct. Cl. 128, 142-143, 376 F.2d 266, 274-275 (1967), *cert. denied*, 389 U.S. 1041 (1968); *cf. Federal Maritime Commission* v. *Seatrain Lines, Inc.*, 411 U.S. 726, 745 (1973); *Love* v. *Fitzharris*, 460 F.2d 382, 385 (9th Cir. 1972), *vacated*, 409 U.S. 1100 (1973).

Finally, with relation to the testimony of Mr. Sturtevant, who testified that the unearned premium reserve as reported by American Bankers and plaintiff was permitted "unwittingly" by the Georgia insurance authorities, we have reviewed his testimony and it does not change our interpretation of the Georgia law above expressed.

For the foregoing reasons, we hold that the plaintiff is entitled to recover.

NICHOLS, *Judge*, dissenting:

The dissent in *Penn Security Life Insurance Company* v. *The United States*, Ct. Cl. No. 109-68 announced this date is to be deemed as being applicable to this case.

FINDINGS OF FACT

History of the Controversy

1. For each of the taxable years 1958 through 1965, plaintiff filed a timely tax return and paid all taxes shown thereon to be due. The taxes paid in said years were as follows:

1958: $48,144.32	1961: $17,777.24	1964: $17,726.51
1959: $72,405.55	1962: $17,047.52	
1960: $52,377.05	1963: $43,790.32	

Such tax liability of plaintiff in all such years was computed in accord with Section 802 of the Internal Revenue Code of 1954.

2. Under date of February 20, 1969, the Acting Regional Commissioner, Internal Revenue Service, Southeast Region, sent plaintiff a notice of deficiencies in federal income taxes in the aggregate amount of $233,762.75, plus interest, for the taxable years ended December 31, 1958, 1959, 1960, 1962, 1963, and 1964. (Recomputation for 1961 resulted in a refund due

plaintiff.) The statement accompanying said notice of deficiency set forth the reasons for the alleged deficiencies in federal income taxes as follows:

> "It is determined that for your taxable years 1958, 1959, 1960, 1962, 1963 and 1964, you did not qualify as a life insurance company within the meaning of section 801 of the Internal Revenue Code of 1954, entitling you to taxation under section 802 of the 1954 Code. Consequently, your taxable income is being computed under Section 832 of the 1954 Code. This determination is based on the following:
>
> "(1) You did not compute or estimate your life insurance reserves on credit life contracts on the basis of a recognized Mortality Table and assumed rates of interest, as required by section 801(b) of the 1954 Code, and/or
>
> "(2) You did not reflect in your total reserves, defined in Section 801(c) of the 1954 Code certain unearned premiums on accident and health contracts under certain reinsurance agreements which should have been included therein. Accordingly, when your total reserves are corrected, your life insurance reserves as reported, even if recognized as having been computed or estimated on a basis of a recognized mortality table, would not exceed 50% of your correct total reserves pursuant to section 801(a) of the 1954 Code."

3. On or about July 30, 1969, plaintiff paid to the District Director the aggregate amount of $351,393.88 for additional federal income taxes and interest thereon for the taxable years ended December 31, 1958, 1959, 1960, 1962, 1963, and 1964.

4. On or about October 14, 1969, plaintiff filed with the District Director Claims for Refund of taxes and interest in the respective amounts and for each of the taxable years as described in paragraph 3 above. On or about June 26, 1970, plaintiff filed amended Claims for Refund of taxes and interest in the respective amounts and for each of the taxable years as described in paragraph 3 above.

5. On or about October 27, 1970, the District Director notified plaintiff that the aforesaid amended Claims for Refund for the overpayment of taxes and interest had been disallowed.

6. Plaintiff filed its Petition in this Court on December 30, 1970, for recovery of income taxes and interest paid by plaintiff with respect to its claims for its taxable years 1958, 1959, 1960, 1962, 1963, and 1964.

7. Jurisdiction over the subject matter of this action is conferred upon this Court under Section 1346 (a) (1), Title 28, United States Code.

Background of Controversy

8. Plaintiff was incorporated as a stock insurance company under the Insurance Code of the State of Arizona on June 26, 1957.

9. Since its incorporation, all of the outstanding stock of plaintiff has been owned by Southern Discount Company (hereinafter referred to as "Southern Discount"), which was during all years pertinent to this lawsuit a Georgia corporation licensed under the consumer finance laws of the states in

which it operated, and was engaged in the consumer finance business. These state laws forbade Southern Discount from acting as an insurance company. They did, however, permit Southern Discount to act as an agent for other insurance companies.

10. Prior to the incorporation of plaintiff, Southern Discount acted as agent for various insurance companies who wrote insurance on the lives and health of Southern Discount's borrowers.

11. Credit life and accident and health insurance is sold in connection with a loan of money or an installment sale of tangible personal property. Credit life insurance, generally defined, is term insurance on the lives of debtors, with their creditors as beneficiaries, in amounts at least sufficient to discharge their indebtedness in case of death. Sometimes the life coverage is combined with accident and health coverage. Such coverage pays the debtor's monthly installments during the period within the policy term in which he is totally disabled (*i.e.*, unable to work) because of accident or sickness, provided that the disability lasts beyond a minimum or "waiting" period. Coverage may be conditioned upon the permanent as well as total disability of the debtor. When life and accident and health coverage are provided in one contract, the respective premiums are separately stated.

12. As agent in the sale of such insurance, Southern Discount was able to share in its profitability by earning a commission, the amount of which, however, was limited by state law. By causing plaintiff

to be formed, Southern Discount was able to participate to a greater degree in the profitability of this business, when it was profitable, by actually engaging in the insurance underwriting function either directly or through its reinsurance.

13. The initial capital and paid-in surplus upon the incorporation of plaintiff in 1957 was $38,000.00. In 1959 plaintiff's stated capital was increased by $175,000.00 so as to qualify plaintiff to write insurance in the State of Georgia.

14. Plaintiff's Articles of Incorporation provide, among other powers designated therein, that the nature of the business, and objects or purposes to be transacted, promoted or carried on are:

> "(a) To insure, in its own proper and corporate name, the lives of persons and all insurance appertaining thereto, including, but not limiting the generality of the foregoing: term, industrial, retirement income, ordinary, modified, single premium, limited payment, group and all other types and forms of contracts of insurance upon or relating to the lives of persons in connection with the extension of credit to such persons.
>
> (b) To reinsure all or a part of any risk, class of risks, or all of the risks of the Company with any other insurance company or companies, and to accept such reinsurance from any other insurance company or companies, as allowed by law."

15. During all of the taxable years in issue in this case, plaintiff was licensed by the Insurance

Commissioner of the State of Arizona to transact life and disability insurance business. During the taxable years in issue the Arizona Department of Insurance conducted regular examinations of plaintiff's business activities and reports of examination were issued in 1959 and 1963.

16. American Bankers Life Assurance Company (hereinafter referred to as "American Bankers") is an insurance company licensed to engage in the life and disability insurance business under the laws of the State of Florida.

17. Other than as a party to certain treaties described more particularly below, American Bankers was totally unrelated to plaintiff at its inception and has remained an unrelated company except for its ownership of a nominal amount of stock (approximately 2½%) in plaintiff's parent corporation, Southern Discount, from March 15, 1962, until March 25, 1969, and approximately 1% acquired in 1972 and disposed of in the following year.

18. Reinsurance is a transaction in which an insurance company (the writing company, or ceding company) transfers, at least temporarily, the responsibility for all or a portion of the claims on which it may eventually be liable under the policies it has written, to another company (the reinsurer). The ceding company pays the reinsurer consideration for assisting the ceding company in spreading, or averaging, its liabilities or risk over time. Reinsurance may be entered into for numerous reasons, including freeing one company's capital or surplus

from restrictions imposed for reserves required, spreading risks over time, avoiding catastrophic losses, the alliance of a small, new company with an older, experienced company for business purposes, sharing profitability of the industry where business considerations require that, and avoiding fluctuations of yearly earnings.

19. During the years 1958 through 1961, plaintiff's business consisted of reinsuring all policies of insurance against the death or disability of debtors of Southern Discount and certain of its subsidiaries, which insurance policies had been issued by American Bankers. For plaintiff to have written insurance directly, rather than to have acted as a reinsurer, plaintiff would have been required to possess total stated capital and capital surplus of some $400,000.00 at this time in the State of Georgia. Plaintiff's intent was to act as a reinsurer, permissible with a smaller capital investment, and increase its surplus through the profitability of the business until plaintiff could qualify to write insurance directly. This method of conducting business relieved Southern Discount, plaintiff's parent company, from the financial burden of contributing to plaintiff's capital a large amount of cash and thereby enabled Southern Discount to utilize its available cash to produce a more attractive return through its consumer lending business.

20. This reinsurance was effected pursuant to the terms of a reinsurance treaty entered into by the parties and dated June, 1957, which agreement was

amended from time to time thereafter. (This period is hereafter referred to as "Period I" and this treaty and its amendments as "Treaty I." See paragraphs 56-58.)

21. The reinsurance treaties executed by plaintiff and American Bankers were arms-length agreements entered into for valid business purposes by unrelated parties.

22. American Bankers realized that if Southern Discount created a subsidiary insurance company which operated alone or under reinsurance treaties with other companies, the insurance business generated by loans on Southern Discount's customers would be lost completely by American Bankers.

23. In 1962, plaintiff having qualified to write insurance directly in the States of North Carolina and Georgia, its primary business became the direct writing of life and accident and health insurance on the debtors of Southern Discount and certain of its subsidiaries. This business continued to be plaintiff's primary business throughout the remainder of the years in issue ("Period II"), although plaintiff continued to reinsure certain policies under Treaty I until they expired according to their terms.

24. A certain percentage of the accident and health policies written directly by plaintiff during Period II were reinsured by American Bankers pursuant to the terms of a Reinsurance Treaty entered into between the parties on April 18, 1962. ("Treaty II." See paragraphs 59-61.)

25. Treaty II was entered into by plaintiff and American Bankers in 1962 for valid business reasons. The cession to American Bankers, on an "as written" basis, as described below, of a majority of the credit accident and health insurance which plaintiff wrote meant that plaintiff was not required under state law to maintain any unearned premium reserves on said insurance. Had full reserves, in the amount of 100% of the unearned premiums, been maintained by plaintiff with respect to said insurance, plaintiff's earnings and the consolidated earnings and capital of Southern Discount would have been adversely affected, with consequent damage to Southern Discount's borrowing power, which was of great import in its primary business.

26. Treaty II was an arms-length agreement between plaintiff and American Bankers. In addition to its effect on plaintiff's reserve requirements, Treaty II permitted plaintiff to dilute the effect on its capital and surplus at any given time, of accident and health insurance claims, thus serving the traditional role of reinsurance in deferring risk and providing protection for plaintiff and its customers in the event of any catastrophic loss experience, since American Bankers' obligations under the treaty were not limited in any way.

Qualification as a Life Insurance Company

27. Section 801 of the Internal Revenue Code of 1954 provides an objective test for determining whether an insurance company is a "life insurance

company" and therefore permitted to reports its income in the method prescribed by Section 802. The qualification formula may be expressed in terms of the following fraction, the quotient of which must be more than 50 percent in order for an insurance company to qualify as a life insurance company.

Qualifying reserves (numerator)	÷	Total reserves (denominator)
1. Tabular reserves on life, annuity, and noncancellable accident and health policies		1. Tabular reserves on life, annuity, and noncancellable accident and health policies
2. Unearned premiums on noncancellable life, health, or accident policies not included in (1)		2. Unearned premiums not included in (1)
3. Unpaid losses on noncancellable life, health, or accident policies not included in (1)		3. Unpaid losses not included in (1)
		4. All other insurance reserves required by law.

28. Plaintiff did not physically hold, nor did it exercise control over, those unearned premiums representing accident and health insurance reserves which the Commissioner of Internal Revenue attributed to plaintiff for purposes of measuring plaintiff's "total reserves." The accident and health reserves were held by American Bankers and the investment income therefrom received by it.

29. Plaintiff maintained life insurance reserves with respect to life insurance reinsured pursuant to Treaty I. Similarly, plaintiff maintained life insur-

ance reserves with respect to life insurance written by plaintiff during Period II.

30. Historically, life insurance reserves are maintained by an insurance company to enable the company to pay those claims which may reasonably be expected to result from the life insurance policies it has issued. The computation of life insurance reserves is based upon mortality tables which contain statistics as to average life expectancies for certain ages and sexes. By applying these statistics to the ages and sexes represented by a company's actual policyholders, a reasonably accurate prediction of the amount necessary to meet future claims may be made. (Although the amount will vary according to the mix of policyholders for any particular company, the amount of reserves normally required was approximately 40 percent of premiums received for the policies covered by Treaty I.)

31. Traditionally, whether because accident and health insurance exposure was initially incapable of being measured statistically (although records have been maintained sufficiently by this time that a reasonable reserve requirement could probably be reached by using statistics), or perhaps because this insurance, unlike life insurance, is usually cancellable, accident and health reserves are required to be computed in terms of how much of a premium would have to be refunded to a policy holder in the event the policy were cancelled at any particular time during its term. The reserve so maintained is referred to as the "unearned premium reserve." This method of establishing reserves is the established method of

computing reserves for health and accident insurance.

32. All credit life and credit accident and health policies issued by American Bankers and reinsured by plaintiff, and those issued by plaintiff and reinsured by American Bankers, provided for payment of the entire premium at the time of issuance. This is referred to in the industry as "single premium" payment. When a health and accident premium under such a "single premium" policy is first paid by the insured, it is wholly "unearned" in that the entire premium has been paid for coverage over the full term of the policy, which has not yet been provided. Such unearned portion is set aside on the books and records of the company as the unearned premium reserve. As the term of the policy expires with the passage of time, the premium becomes "earned" to the extent of such expiration, since that portion was paid for coverage which was provided during the expired portion of the policy.

33. An unearned premium reserve thus measures an insurance company's reserve requirements by looking to premiums already paid by policyholders and then determining the portion of such premiums that represent payment for insurance to be provided after the reserve valuation date.

34. In the event that the policies issued by American Bankers or by plaintiff to the debtors, in Period I or II, were cancelled by some act prior to the expiration of their original terms, the refund of the unearned portion of the premiums would be made in

pursuance to their terms in accordance with a prescribed formula known as the Rule of 78.

35. Under the Rule of 78 or "sum-of-the-digits" method, the unearned premium is computed by applying changing fractions each year (or month, if unearned premiums are determined monthly) to the premium paid by the insured. The numerator of the fraction changes each year (or month) to a number which corresponds to the sum of the digits of the remaining unexpired term (years or months) of the policy, and the denominator, which remains constant, is the sum of all the years' (or months') digits corresponding to the entire term of insurance coverage. For example, if an insured debtor paid a $300 premium for disability benefits at the inception of a three-year single premium policy, he would be entitled to a refund under the Rule of 78 of $300 $\left(\frac{3+2+1}{3+2+1}\text{X}\$300\right)$ if the policy was terminated at the beginning of the first year, $150 $\left(\frac{2+1}{3+2+1}\text{X}\$300\right)$ if the policy was terminated at the beginning of the second year, and $50 $\left(\frac{1}{3+2+1}\text{X}\$300\right)$ if the policy was terminated at the beginning of the third year.

36. The unearned premium reserve for accident and health insurance is therefore 100 percent of the gross accident and health premium at the outset of a policy term. It is impossible for an insurance company to maintain such a reserve unless it has other funds besides the premium in question, since other

costs such as the agent's commission and administrative expenses must also be paid from the same premium. Even with other funds the restriction on capital imposed by such a reserve requirement is severe.

37. It has become customary in the industry to structure reinsurance treaties (which serve other valid business purposes of leveling the peaks and valleys in a particular company's liability pattern) in such a way that the larger, high-capital party to the treaty maintains the reserves required for any accident and health insurance involved. Thus the party whose capital can bear the burden of the restriction imposed by "unearned premium reserves" will physically hold those reserves and collect the investment income from them.

38. The result of plaintiff's treaties with American Bankers was that plaintiff was not required to maintain reserves for the accident and health insurance reinsured or written directly by it, to the extent said business was subject to those treaties.

39. In Treaty I, the accident and health insurance written by American Bankers was reinsured by plaintiff on a month-to-month basis, as it became "earned." The single premium received by American Bankers at the creation of the policy was held by American Bankers and remitted on a monthly basis, net of a 12½% retention, to plaintiff, as payment for the reinsurance being provided to American Bankers. American Bankers maintained the "unearned premium reserves" on said policies; plaintiff maintained no reserves. Plaintiff's obligation to reimburse American Bankers for insurance claims incurred was lim-

ited in the aggregate to the amount it received from American Bankers according to the treaty.

40. Plaintiff was not required by the state regulatory agencies to establish an unearned premium reserve with respect to its reinsurance of American Bankers' accident and health insurance policies under Treaty I because as of each payment from American Bankers to plaintiff, all such reinsurance premiums had been fully earned by plaintiff, and no portion of the reinsurance premiums received and held by plaintiff represented payment for insurance to be provided after the payment date.

41. Under Treaty II, plaintiff reinsured 80 percent (and later 65 percent) of the accident and health insurance, which it now wrote directly, with American Bankers. This reinsurance was not ceded on a month-to-month basis as earned, but all at once from the outset of the policy term. Plaintiff therefore remitted the entire premium, less commissions to agents, for the portion reinsured to American Bankers initially. American Bankers' obligation to reimburse plaintiff for insurance claims incurred was not limited in any way. American Bankers, holding the premiums, therefore established the reserves required for such insurance. Plaintiff established no such reserves.

42. Plaintiff was not required by any state regulatory agency to establish any unearned premium reserves as to insurance ceded by it to American Bankers under Treaty II because plaintiff held no unearned premiums on such policies, but instead received credit for reserves properly established by American Bankers, which did hold those premiums.

43. The unearned premiums and corresponding reserves in question under both treaties were physically held by American Bankers, which received the investment income therefrom, and which reported said reserves for purposes of state regulation as well as taxation. Plaintiff did not obtain or use the unearned premiums reflected in the annual statements of American Bankers, nor were said unearned premiums credited, set apart, or made available to plaintiff. There was no common or direct control of American Bankers by plaintiff or vice versa.

44. There was no existing state law which would have had the effect of "attributing" to plaintiff any reserves held by American Bankers on the insurance which was the subject of Treaties I and II. As unrelated parties to arms-length agreements, both plaintiff and American Bankers received benefits and gave consideration for said benefits under these treaties. The unearned premiums received by American Bankers were subject to no control or other proprietary interest on the part of plaintiff.

45. Under Treaty I, plaintiff had no obligation to refund premiums paid by policyholders of American Bankers in the event of premature termination of policies issued by American Bankers, since plaintiff received such premiums only after they had been fully earned. Consequently, there was no need, either legal or practical, for plaintiff to establish an unearned premium reserve for the purpose of maintaining a fund available for the refund of premiums.

46. Under Treaty II, since American Bankers received the accident and health premiums before they were earned, and since American Bankers' obligation to bear the cost of claims was not limited in any way, American Bankers properly maintained unearned premium reserves as to the portion of such policies reinsured.

47. The treaties in question and the method of maintaining reserves pursuant thereto were not unusual in the insurance industry at this time, and are still in use. The maintenance of said reserves was proper from an actuarial and an accounting point of view. It is standard in reinsurance accounting that the company which possesses the unearned premiums is the only company required to maintain the reserves thereon, unless one of the companies is not a qualified reinsurer.

48. The insurance industry is regulated by the states. A particular insurance company must meet the various industry requirements of its home state, and must satisfy the requirements of all states in which it is qualified to act as an insurer. The state requirements include standards for investments, maintenance of reserves, and accounting practices. The state insurance departments supervise policy forms, agency relationships, and the general financial activities of the companies within their jurisdictions. This regulation is designed to preserve the solvency of the insurance companies for the protection of policyholders.

49. To implement their regulatory function, state insurance departments require companies to file annual reports. Because reports are required in all states in which a company is qualified to act as an insurer, a standard report form has been developed by the National Association of Insurance Commissioners, which is used in all fifty states. These reports disclose, among other things, the reserves being maintained by each company.

50. In addition to requiring annual reports, the various state insurance departments conduct regular triennial examinations of insurance companies. Where the volume of business warrants it as to a particular company, it is customary for representatives of several state insurance departments to work together on these examinations. The examinations are carried out at the offices of the company in question, and may take as long as several months for large companies. Among the matters which are investigated in the course of such an examination are the reinsurance treaties to which a particular company is a party.

51. When a state insurance department is presented with a reinsurance agreement in existence between parties, its investigation will include a determination that each party has established adequate reserves according to its respective liabilities pursuant to the terms of the reinsurance agreement.

52. Plaintiff was the subject of triennial examinations in 1959 and 1963 by the insurance department of Arizona.

53. American Bankers was the subject of triennial examinations in 1960 and 1963. Participants in the 1960 examination were from the insurance departments of Florida, North Carolina, Georgia, and Texas; and participants in the 1963 examination were from the insurance departments of Florida, Georgia, Arizona, and Arkansas.

54. The reinsurance treaties between plaintiff and American Bankers were examined in detail in the course of the aforesaid examinations. The existence of reserves for accident and health insurance held by American Bankers on the policies covered by those treaties was clear to the examiners. Also the maintenance of the reserves by American Bankers under the treaties during Period I and Period II was approved in the course of the four examinations; no requirement or even suggestion was made in the examination reports that the reserves should be otherwise maintained.

55. There is no federal law pertaining to the matters of regulation which constitute the responsibility of the various states as described above.

56. Insofar as pertinent to this litigation, Treaty I read as follows:

ARTICLE I

American Bankers agrees to cede to *Consumer Life* and *Consumer Life* agrees to accept reinsurance to the extent set forth below:

One Hundred Per Cent (100%) of each and every Life policy and each and every Health and Accident policy (herein called "Life policies" and

"Health and Accident policies") issued by American Bankers in respect to debtors of *Consumer Life* and its subsidiary and affiliated corporations. The liability of *Consumer Life* under said Life and Health and Accident policies shall follow the liability of American Bankers except that the liability of *Consumer Life* arising under its reinsurance of said Health and Accident policies is on a month to month basis only and is limited solely to such amounts as shall become payable by *Consumer Life* under the provisions of Article V prior to the termination of this agreement.

ARTICLE II

This agreement applies to all said policies issued by American Bankers on or after the *1st* day of *July*, 1957.

ARTICLE III

American Bankers shall furnish *Consumer Life* on or before the 20th day of *July*, 1957 and on or before the 20th day of each month thereafter, a statement showing the following information on transactions of the preceding month:

A. On all Life policies the statement will show:

(1) The amount of premiums collected;
(2) The amount of premiums returned on account of cancellation or other reason; and
(3) The amount of losses paid.

B. On all Health and Accident policies the statement will show:

(1) The amount of premiums collected;

(2) The amount of premiums returned on account of cancellation or other reason;

(3) The amount of losses paid;

(4) The amount of losses reported and unpaid and the estimated amount of losses incurred and unreported at the end of the preceding month; and

(5) The amount of premiums earned.

For the purpose of computing premiums earned during any month on Health and Accident policies under this Article III, the sum of the premiums collected on policies written during the month less any premium returned because of cancellation or other reason during the month, shall be added to the unearned premium reserve at the beginning of the month on policies then in force, and from the total sum so obtained shall be subtracted the unearned premium reserve at the end of the month on policies in force at that time.

For the purpose of computing losses, losses reported and unpaid and losses incurred and unreported, the allocated loss expense shall be added to the amount of loss claims. In this connection the allocated loss expense shall be all claim expenses over and above the usual claim expenses incurred in the routine handling of a claim in the ordinary course of business, it being the intent of the parties hereto to include such expenses as the hiring of a special investigator, unusual travel expense in connection with the handling of a claim, attorney's fees arising from a claim and other expenses not incurred in the usual and ordinary course of handling a claim.

ARTICLE IV

In addition to the monthly statement set forth in Article III, American Bankers agrees to furnish *Consumer Life* on or before the 20th day of January each year and from time to time as may be requested by *Consumer Life*, but in no event more often than monthly, a statement containing the following information as at the end of the month preceding the statement:

A. The amount of reserve on all life policies then in force;

B. The amount of losses on Life policies reported and unpaid and the estimated amount of losses incurred but unreported;

C. The amounts of insurance on all Life policies;

D. Such other information as may be required to complete annual statements or other statements as required by law.

Consumer Life shall, at all reasonable times during this agreement, have full and free access to all books, records and files of American Bankers' office with respect to the business covered by this agreement.

ARTICLE V

In consideration of the reinsurance as set forth in Article I, the American Bankers agrees to pay monthly to *Consumer Life*, based on the statement set forth in Article III for the preceding month, and payable at the same time: (1) Eighty-seven and One-half Per Cent (87½%) of the premiums collected less any premiums returned on all Life policies, and (2) Eighty-seven

and One-half Per Cent (87½%) of the premiums earned on all Health and Accident policies.

Consumer Life agrees to reimburse American Bankers before the 30th day of the month after such statement is submitted, for all losses actually paid during the preceding month on Life policies and all losses actually paid during the preceding month on Health and Accident policies plus any increase or less any decrease during said month in the amount of Health and Accident losses reported and unpaid and incurred and unreported.

ARTICLE VI

American Bankers shall maintain all unearned premiums, loss and other reserves as may be required by law against all Health and Accident policies. *Consumer Life* shall maintain policy and other reserves as may be required by law on all Life policies.

ARTICLE VII

American Bankers agrees to pay all state, county, or city taxes which may be or become due in connection with the insurance sold or premiums collected on policies reinsured under this agreement.

ARTICLE VIII

American Bankers has furnished to *Consumer Life* and *Consumer Life* has acknowledged having received from American Bankers specimen forms upon which all said policies covered hereby

are currently written. American Bankers reserves the right to make changes in such forms from time to time, but shall promptly notify *Consumer Life* of all such changes.

ARTICLE IX

The supervision and payment of all claims on policies covered by this agreement shall be handled by American Bankers and the decision of American Bankers in settling, rejecting or defending such claims shall be binding on *Consumer Life.*

ARTICLE X

In the event of the insolvency of the American Bankers, all reinsurance shall be payable directly to the liquidator, receiver or statutory successor of said American Bankers, without diminution because of the insolvency of American Bankers.

In the event of insolvency of American Bankers, the liquidator, receiver or statutory successor shall give *Consumer Life* written notice of the pendency of a claim on the policy reinsured within a reasonable time after such claim is filed in the insolvency proceeding. During the pendency of any such claim, *Consumer Life* may investigate such claim and interpose in the name of American Bankers (its liquidator, receiver or statutory successor,) but at its own expense, in the proceeding where such claims are to be adjudicated, any defense or defenses which *Consumer Life* may deem available to American Bankers or its liquidator, receiver or statutory successor.

ARTICLE XI

All disputes and differences between the two contracting parties upon which an amicable understanding cannot be reached are to be decided by arbitration and the arbitrators, who shall regard this agreement from the standpoint of practical business and equity rather than from that of the strict law, are empowered to determine as to the interpretation of the agreement obligation.

The court of arbitrators which is to be held in the city of Miami, Florida, shall consist of three arbitrators who must be officers of life insurance companies other than the two parties of this agreement. One of the arbitrators is to be appointed by American Bankers, the second by *Consumer Life* and the third is to be selected by these two representatives before the beginning of the arbitration. Should one of the parties decline to appoint an arbitrator or should the two arbitrators be unable to agree upon the choice of a third, the appointment shall be left to the president of the American Life Convention.

The arbitrators are not bound by any rules of law. They shall decide by a majority of votes and from their written decision there can be no appeal. The cost of arbitration, including the fees of the arbitrators, shall be borne by the losing party unless the arbitrators shall decide otherwise.

ARTICLE XII

This agreement constitutes the entire contract between the parties and may not be altered, modified or in any ways amended except by an instrument in writing duly executed by the proper official of both parties.

ARTICLE XIII

This agreement may be terminated by either party effective on the last day of any month upon at least thirty (30) days written notice of the other party.

Upon termination by either party, this agreement shall continue to apply to all policies reinsured hereunder before such termination becomes effective.

IN WITNESS WHEREOF, the parties hereto have caused this instrument to be signed and sealed by their duly authorized officers on this *28* day of *June*, 1957.

57. By amendments effective November 1, 1957 and April 1, 1958, American Bankers' retained share of the total premiums received annually in excess of $200,000 was reduced from 12½ percent, as provided in Article V of Treaty I, finding 56, *supra*, to 9½ percent.

58. Treaty I was further amended May 28, 1958, effective as of July 1, 1957, to revise the extent of plaintiff's interim liability as the reinsurer of American Bankers' exposure under the A & H coverages subject to the Treaty. At all times, however, plaintiff reinsured the entire risk represented by those coverages, the only change being in the timing of its loss indemnity payments to American Bankers. At the time of this amendment plaintiff had accumulated a surplus fund of $130,000 from A & H pre-

mium receipts out of which to meet its reinsurance obligations which were averaging approximately $3,000 per month.

59. Treaty II is recited in toto. It read as follows:

ARTICLE I

Basis of Reinsurance

1. On and after the effective date hereof, the Ceding Company's liability under Credit Accident and Sickness policies issued directly by the Ceding Company on the policy forms specified in Schedule A, attached hereto, shall be reinsured automatically to the degree and in the manner hereinafter specified.

2. The reinsurance liability of American Bankers during 1962 shall be 80% of each policy issued by the Ceding Company; thereafter, with respect to new business, such reinsurance liability may be reduced at the option of the ceding company at the beginning of each subsequent calendar year.

3. Reinsurance hereunder shall apply and be subject to all benefits and limitations included in policies issued by the Ceding Company and subject to reinsurance hereunder.

ARTICLE II

Mode of Cession

1. Reinsurance of Credit Accident and Sickness insurance issued or renewed by the Ceding Company on and after the effective date of this Agreement shall be effected by the Ceding Com-

pany's mailing to American Bankers a reinsurance cession on a form of which a sample is attached hereto and marked Schedule B, not later than the twentieth day following the last day of the calendar quarter covered by the reinsurance cession. The liability of American Bankers shall:

(a) commence as of the effective dates of the reinsurance premiums, and

(b) continue only for the period covered by the reinsurance premiums.

2. In no event shall the reinsurance be in force and binding unless the policy issued by the Ceding Company to the insured is in force.

ARTICLE III

Reinsurance Premiums

1. The reinsurance premiums to be paid the American Bankers by the Ceding Company shall be the premiums charged the insured by the Ceding Company during the calendar quarter for the coverage reinsured.

2. American Bankers will pay to the Ceding Company a commission of 50% of reinsurance premiums received, as specified in this Article, on reinsurance hereunder.

ARTICLE IV

Oversights

1. American Bankers shall be bound as the Ceding Company is bound, and it is expressly understood and agreed that if non-payment of premiums within the time specified or failure to

comply with the terms of this Agreement is shown to be unintentional and the result of misunderstanding or oversight on the part of either the Ceding Company or American Bankers, both the Ceding Company and American Bankers shall be restored to the positions they would have occupied had no such error or oversight occurred.

ARTICLE V

Payment of Claims

1. At the end of each calendar quarter American Bankers shall reimburse the Ceding Company for American Bankers share of all claim payments made by the Ceding Company during the calendar quarter on policies reinsured hereunder.

2. It is hereby understood and agreed that the American Bankers shall be liable only for claims incurred on or after the effective date hereof.

ARTICLE VI

Experience Refunds

1. Reinsurance ceded hereunder shall be eligible for an Experience Refund. The Experience Refund for a given calendar quarter shall be computed as follows:

Experience Refund = (P-Co-E-Cl)

where P = earned reinsurance premiums during the calendar quarters as determined by American Bankers.

Co = earned reinsurance commission during the calendar quarter as determined by American Bankers.

E = an expense, profit, and contingency charge equal to .03P.

Cl = incurred reinsurance claims during the calendar quarter as determined by American Bankers.

2. If P-Co-E-Cl is negative for a given calendar quarter such negative amount will be treated as an addition to the incurred claims in calculating the Experience Refund for the following calendar quarters.

ARTICLE VII

Taxes, Assessments and Expenses

Neither party hereto shall be liable to the other for taxes, assessments, or any expenses resulting from reinsurance hereunder. The Ceding Company shall furnish the American Bankers with all necessary information so that American Bankers will not be required to perform any office work other than the regular bookkeeping entries made in connection with reinsurance accounting.

ARTICLE VIII

Inspection of Records

American Bankers shall have the right at any reasonable time to inspect at the office of the Ceding Company all books and documents relating to the reinsurance under this Agreement.

ARTICLE IX

Insolvency

1. In the event of insolvency of the Ceding Company, all reinsurance in force shall be payable to its liquidator or receiver without diminution because of the insolvency of the Ceding Company by any court of competent jurisdiction or any justice or judge thereof, or by any receiver or liquidator having authority to determine and allow such claims. It is understood, however, that in the event of the insolvency of the Ceding Company, the liquidator, receiver or statutory successor of the Ceding Company shall give written notice of the pendency of a claim against the Ceding Company on the policy reinsured with[in] a reasonable time after such claim is filed in the insolvency proceedings and that during the pendency of such claim the American Bankers may investigate such claim and interpose, at its own expense, in the proceedings where such claim is to be adjudicated any defense or defenses which it may deem available to the Ceding Company or its liquidators or receiver or statutory successor.

2. The expense thus incurred by American Bankers shall be chargeable against the Ceding Company as part of the expense of liquidation to the extent of a proportionate share of the benefit which may accrue to the Ceding Company solely as a result of the defense undertaken by American Bankers.

ARTICLE X

Settlement of Claims

1. American Bankers shall be liable to the Ceding Company for the benefits covered by reinsurance hereunder to the same extent as the Ceding Company is liable to the insured for such benefits and all reinsurance shall be subject to the terms and conditions of the particular form of policy under which the Ceding Company shall be liable.

2. It is hereby understood and agreed that the American Bankers shall be liable only for claims incurred on or after the effective date hereof.

3. Whenever a claim is made under a policy of the Ceding Company, which has been reinsured hereunder, it shall be taken and considered by American Bankers to be a claim for the amount of reinsurance on such risk and American Bankers shall abide the issue as it shall be settled by the Ceding Company and shall pay the amount of reinsurance covered by the policy of reinsurance when the Ceding Company shall settle with the Claimant.

4. Any suit or claim may be contested or compromised on the part of the Ceding Company and in case of a reduction of the claim made upon the Ceding Company, American Bankers and the Ceding Company shall participate in such reduction in the ratio that each company's net liability bore to the total net liability prior to the reduction of the claim. Any unusual expenses incurred by the Ceding Company in defending or investigating any claims or taking

up or rescinding any policy reinsured hereunder aside from routine investigations and other expenses incidental to the settlement of claims shall be shared in the same proportion.

5. In every case of loss, copies of proofs obtained by the Ceding Company shall likewise be taken as sufficient by American Bankers and copies thereof, together with a statement showing the amount paid on such claim by the Ceding Company shall be furnished to American Bankers before payment shall be demanded of it.

ARTICLE XI

Arbitration

1. All disputes and differences between the two contracting parties upon which an amicable understanding cannot be reached are to be decided by arbitration and the arbitrators, who shall regard this treaty from the standpoint of practical business and equity rather than from that of the strict law, are empowered to determine as to the interpretation of the treaty obligation.

2. The court of arbitrators which is to be held in the City of Miami, Florida, shall consist of three arbitrators who must be officers of life insurance companies other than the two parties of this Agreement. One of the arbitrators is to be appointed by the Ceding Company, the second by American Bankers and the third is to be selected by those two representatives before the beginning of the arbitration. Should one of the parties decline to appoint an arbitrator or should the two arbitrators be unable to agree upon the

choice of a third, the appointment shall be left to the counsel for the Consumer Credit Insurors Association.

3. The arbitrators are not bound by any rules of law. They shall decide by a majority of votes and from their written decision there can be no appeal. The cost of arbitration, including the fees of the arbitrators, shall be borne by the losing party unless the arbitrators shall decide otherwise.

ARTICLE XII

Parties to Agreement

This is an agreement solely between the Ceding Company and American Bankers. The acceptance of reinsurance hereunder shall not create any right or legal relation whatever between American Bankers and the insured or the beneficiary under any policy of the Ceding Company which may be reinsured hereunder.

ARTICLE XIII

Duration

1. This agreement shall be effective as of the 1st day of March 1962, and may be terminated as of the end of any calendar quarter by either party giving to the other not less than 30 days' written notice.

2. Upon termination, as provided in this Article, the Ceding Company shall, within 30 days of the termination date, supply American Bankers with the information necessary to calculate the final experience refund as of the termination date. Payment of (a) the final experience re-

fund, (b) the unearned premium reserve held by American Bankers less unearned commissions thereon, and (c) payment of the claim reserve held by American Bankers.

60. On December 2, 1964, effective October 1, 1964, plaintiff and American Bankers executed the following amendment to Treaty II:

ADDENDUM TO REINSURANCE AGREEMENT

THIS AGREEMENT, made this 2nd day of December, 1964, and effective the 1st day of October, 1964, by and between CONSUMER LIFE INSURANCE COMPANY OF PHOENIX, ARIZONA, hereinafter designated as "Ceding Company" and AMERICAN BANKERS LIFE ASSURANCE COMPANY OF FLORIDA, a corporation duly organized and existing under and by virtue of the laws of the State of Florida and having its executive office in the City of Miami, and State of Florida, hereinafter designated as "Company".

WITNESSETH:

WHEREAS, the Company and the Ceding Company entered into a Reinsurance Agreement on the 1st day of March, 1962; and

WHEREAS, the parties are mutually desirious of amending said Agreement as hereinafter set forth.

NOW, THEREFORE, IT IS MUTUALLY UNDERSTOOD AND AGREED AS FOLLOWS:

1. The terms and conditions of said Reinsurance Agreement are incorporated within the terms of this Agreement.

2. Article I, Paragraph (2) is hereby amended to read:

> The reinsurance liability of American Bankers shall be 65% of each policy issued by the Ceding Company; thereafter, with respect to new business, such reinsurance liability may be reduced at the option of the Ceding Company at the beginning of each subsequent calendar year.

3. All other conditions are to remain the same.

61. On December 29, 1964, effective December 31, 1964, plaintiff and American Bankers executed the following further amendment to Treaty II:

AMENDMENT TO Reinsurance Agreement between Consumer Life Insurance Company of Phoenix, Arizona, and American Bankers Life Assurance Company of Florida, of Miami, Florida, dated April 18, 1962.

Article VI of above mentioned Reinsurance Agreement is hereby amended to read as follows:

ARTICLE VI

Experience Refunds

1. Reinsurance ceded hereunder shall be eligible for an Experience Refund. The Experience Refund for a given calendar quarter shall be computed as follows:

Experience Refund = (P-Co-E-Cl-N)

where P = earned reinsurance premiums during the calendar quarter as determined by American Bankers.

Co = earned reinsurance commissions during the calendar quarter as determined by American Bankers.

E = an expense, profit, and contingency charge equal to .03P.

Cl = incurred reinsurance claims during the calendar quarter as determined by American Bankers.

N = negative carry-forward from prior quarter.

2. If a negative amount is obtained from the calculation of the Experience Refund for a given calendar quarter, such negative amount will be carried forward in calculating the Experience Refund for the following calendar quarter, provided, however, that any unamortized balance of such negative carry-forward will be dropped from the refund calculation after 20 quarters. The "first-in, first-out" principle will apply to the unamortization of two or more negative carry-forwards arising from the experience of different calendar quarters.

IN WITNESS WHEREOF the parties hereto have caused this Amendment to be executed in duplicate this 29th day of December, 1964, and to be effective for calculating the Experience Refund due for the calendar quarter ending December 31, 1964.

ULTIMATE CONCLUSION OF FACT

62. Unearned premiums and the corresponding reserves held pursuant to Treaty I are not includable in plaintiff's "total reserves" for purposes of Internal Revenue Code Section 801.

63. Unearned premiums and the corresponding reserves held pursuant to Treaty II are not includabel in plaintiff's "total reserves" for purposes of Internal Revenue Code Section 801.

64. Plaintiff qualified as a life insurance company for purposes of Section 801 because its life insurance reserves exceeded 50 percent of its total reserves, as that term is defined in Section 801(c), as shown by plaintiff's income tax returns for the years 1958, 1959, 1960, 1962, 1963, and 1964.

CONCLUSION OF LAW

Upon the foregoing opinion and findings of fact, which are made a part thereof, the court concludes as a matter of law that plaintiff is entitled to recover; and judgment is entered to that effect, with the determination of the amount of recovery to be made in further proceedings under Rule 131(c).

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